



Audit Guide

Analytical Procedures

October 1, 2017

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Preface

About AICPA Guides

This AICPA guide has been developed by the AICPA Analytical Procedures Working Group to assist practitioners in performing and reporting on their audit engagements.

AICPA guides may include certain content presented as "Supplement," "Appendix," or "Exhibit." A supplement is a reproduction, in whole or in part, of authoritative guidance originally issued by a standard-setting body (including regulatory bodies) and applicable to entities or engagements within the purview of that standard setter, independent of the authoritative status of the applicable AICPA guide. Both appendixes and exhibits are included for informational purposes and have no authoritative status.

An AICPA guide containing auditing guidance related to generally accepted auditing standards (GAAS) is recognized as an interpretive publication as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of GAAS in specific circumstances, including engagements for entities in specialized industries.

Interpretive publications are issued under the authority of the AICPA Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with GAAS. The members of the ASB have found the auditing guidance in this guide to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

The ASB is the designated senior committee of the AICPA authorized to speak for the AICPA on all matters related to auditing. Conforming changes made to the auditing guidance contained in this guide are approved by the ASB chair (or his or her designee) and the director of the AICPA Audit and Attest Standards staff. Updates made to the auditing guidance in this guide exceeding that of conforming changes are issued after all ASB members have been provided an opportunity to consider and comment on whether the guide is consistent with the Statements on Auditing Standards (SASs).

Any auditing guidance in a guide appendix or exhibit (whether a chapter or back matter appendix or exhibit), though not authoritative, is considered an *other auditing publication*. In applying such guidance, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. Although the auditor determines the relevance of other auditing guidance, auditing guidance in a guide appendix or exhibit has been reviewed by the AICPA Audit and Attest Standards staff, and the auditor may presume that it is appropriate.

Purpose and Applicability

This guide includes illustrations that demonstrate the importance of forming expectations and considering the precision of the expectation, two of the most misunderstood concepts when applying analytical procedures. The concepts discussed are applicable for all three stages of the audit (planning, substantive testing, and review). However, this guide focuses principally on how the concepts are applied to substantive testing because in designing substantive procedures, auditors ordinarily desire a specified level of audit assurance.

Looking Forward

As technology progresses, so will the techniques and tools used to perform a financial statement audit. Understanding how to leverage advances in technology to apply new techniques can help to enhance the relevance and value of the financial statement audit. The use of audit data analytics (ADAs) is one area that has been gaining considerable momentum. ADAs have been defined as "...the science and art of discovering and analyzing patterns, identifying anomalies, and extracting other useful information in data underlying or related to the subject matter of an audit through analysis, modeling, and visualization for the purpose of planning or performing the audit." Simply put, ADAs are techniques that can be used to perform a number of audit procedures (for example, risk assessment, tests of details, substantive analytical procedures, and forming an overall conclusion) to gather audit evidence.

The publication *Guide to Audit Data Analytics* has been developed to introduce auditors who are not familiar with ADAs to basic concepts underlying their use and illustrate examples of how they might be used in practice. The *Guide to Audit Data Analytics* leverages content from this AICPA Audit Guide *Analytical Procedures* while expanding to illustrate how ADAs can be used to perform certain procedures. Practitioners are encouraged to read the *Guide to Audit Data Analytics* for more information about the use of ADAs.

Recognition

Mike Santay
Chair, ASB

Analytical Procedures Audit Guide Revision Task Force (2000–2001)

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Analytical Procedures Working Group (1996–1998)

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Guidance Considered in This Edition

This edition of the guide has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative guidance since the guide was originally issued, and other revisions as deemed appropriate. Relevant guidance issued through October 1, 2017, has been considered in the development of this edition of the guide. However, this guide does not include all audit requirements applicable to an entity or a particular engagement. This guide is intended to be used in conjunction with all applicable sources of relevant guidance.

Authoritative guidance that is issued and effective for entities with fiscal years ending on or before October 1, 2017, is incorporated directly in the text of this guide. The presentation of authoritative guidance issued but not yet effective as of October 1, 2017, for entities with fiscal years ending after that same date is being presented differently than in past editions of this guide. This information is being presented as a guidance update, which is a shaded area that contains information related to the new guidance. The distinct presentation of this content is intended to aid the reader in differentiating content that may not be effective for the reader's purposes.

This guide includes relevant guidance issued up to and including the following:

- SAS No. 133, *Auditor Involvement With Exempt Offering Documents* (AICPA, *Professional Standards*, AU-C sec. 945)

Users of this guide should consider guidance issued subsequent to the preceding item to determine its effect, if any, on entities and engagements covered by this guide. In determining the applicability of recently issued guidance, its effective date should also be considered.

The changes made to this edition of the guide are identified in appendix E, "Schedule of Changes Made to the Text From the Previous Edition." The changes do not include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

PCAOB quoted content is from PCAOB Auditing Standards and PCAOB *Staff Audit Practice Alerts*, ©2015, Public Company Accounting Oversight Board. All rights reserved. Used by permission.

Terms Used to Define Professional Requirements in This AICPA Guide

Any requirements described in this guide are normally referenced to the applicable standards or regulations from which they are derived. Generally, the terms used in this guide describing the professional requirements of the referenced standard setter (for example, the ASB) are the same as those used in the applicable standards or regulations (for example, *must* or *should*).

Readers should refer to the applicable standards and regulations for more information on the requirements imposed by the use of various terms that define professional requirements in the context of the standards and regulations in which they appear.

Certain exceptions apply to these general rules, particularly in those circumstances in which the guide describes prevailing or preferred industry practices, or both, for the application of a standard or regulation. In these circumstances,

the applicable senior committee responsible for reviewing the guide's content believes the guidance contained herein is appropriate for the circumstances.

Applicability of Generally Accepted Auditing Standards and PCAOB Standards

Appendix A, "Council Resolution Designating Bodies to Promulgate Technical Standards," of the AICPA Code of Professional Conduct recognizes both the ASB and the PCAOB as standard-setting bodies designated to promulgate auditing, attestation, and quality control standards. Paragraph .01 of the "Compliance With Standards Rule" (ET secs. 1.310.001 and 2.310.001), requires an AICPA member who performs an audit to comply with the applicable standards. Audits of the financial statements of those entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) are to be conducted in accordance with standards established by the PCAOB, a private sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002. The SEC has oversight authority over the PCAOB, including the approval of its rules, standards, and budget. In citing the auditing standards of the PCAOB, references generally use section numbers within the reorganized PCAOB auditing standards and not the original standard number, as appropriate.

Audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended)—hereinafter referred to as *nonissuers*¹—are to be conducted in accordance with GAAS as issued by the ASB. The ASB develops and issues standards in the form of SASs through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs and their related interpretations are codified in the AICPA's *Professional Standards*. In citing GAAS and their related interpretations, references generally use section numbers within the codification of currently effective SASs and not the original statement number, as appropriate.

The auditing content in this guide primarily discusses GAAS issued by the ASB and is applicable to audits of nonissuers. Users of this guide may find the tool developed by the PCAOB's Office of the Chief Auditor helpful in identifying comparable PCAOB standards. The tool is available at pcaobus.org/standards/auditing/pages/findanalogousstandards.aspx.

Considerations for audits of entities in accordance with PCAOB standards may also be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*. PCAOB guidance included in an AICPA guide has not been reviewed, approved, disapproved, or otherwise acted upon by the PCAOB and has no official or authoritative status.

Applicability of Quality Control Standards

QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), addresses a CPA firm's responsibilities for its system of quality control

¹ See the definition of the term *nonissuer* in the AU-C Glossary (AICPA, *Professional Standards*).

for its accounting and auditing practice. A system of quality control consists of policies that a firm establishes and maintains to provide it with reasonable assurance that the firm and its personnel comply with professional standards, as well as applicable legal and regulatory requirements. The policies also provide the firm with reasonable assurance that reports issued by the firm are appropriate in the circumstances.

QC section 10 applies to all CPA firms with respect to engagements in their accounting and auditing practice. In paragraph .13 of QC section 10, an *accounting and auditing practice* is defined as "a practice that performs engagements covered by this section, which are audit, attestation, compilation, review, and any other services for which standards have been promulgated by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under the "General Standards Rule" (ET sec. 1.300.001) or the "Compliance With Standards Rule" (ET sec. 1.310.001) of the AICPA Code of Professional Conduct. Although standards for other engagements may be promulgated by other AICPA technical committees, engagements performed in accordance with those standards are not encompassed in the definition of an *accounting and auditing practice*."

In addition to the provisions of QC section 10, readers should be aware of other sections within AICPA *Professional Standards* that address quality control considerations, including the following provisions that address engagement-level quality control matters for various types of engagements that an accounting and auditing practice might perform:

- AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*)
- AT-C section 105, *Concepts Common to All Attestation Engagements* (AICPA, *Professional Standards*)
- AR-C section 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services* (AICPA, *Professional Standards*)

Because of the importance of engagement quality, this guide includes appendix D, "Overview of Statements on Quality Control Standards." This appendix summarizes key aspects of the quality control standard. This summarization should be read in conjunction with QC section 10, AU-C section 220, AT-C section 105, AR-C section 60, and the quality control standards issued by the PCAOB, as applicable.

AICPA.org Website

The AICPA encourages you to visit its website at www.aicpa.org and the Financial Reporting Center at www.aicpa.org/frc. The Financial Reporting Center supports members in the execution of high-quality financial reporting. Whether you are a financial statement preparer or a member in public practice, this center provides exclusive member-only resources for the entire financial reporting process and provides timely and relevant news, guidance, and examples supporting the financial reporting process. Another important focus of the Financial Reporting Center is keeping those in public practice up to date on issues pertaining to preparation, compilation, review, audit, attestation, assurance, and advisory engagements. Certain content on the AICPA's websites referenced in this guide may be restricted to AICPA members only.

Select Recent Developments Significant to This Guide

AICPA's Ethics Codification Project

The AICPA's Professional Ethics Executive Committee (PEEC) restructured and codified the AICPA Code of Professional Conduct (code) so that members and other users of the code can apply the rules and reach appropriate conclusions more easily and intuitively. This is referred to as the AICPA Ethics Codification Project.

Although PEEC believes it was able to maintain the substance of the existing AICPA ethics standards through this process and limited substantive changes to certain specific areas that needed revision, the numeric citations and titles of interpretations have all changed. In addition, the ethics rulings are no longer in a question and answer format but, rather, have been drafted as interpretations, incorporated into interpretations as examples, or deleted where deemed appropriate. Examples follow:

- Rule 101, *Independence* (ET sec. 101.01) is referred to as the "Independence Rule" (ET sec. 1.200.001) in the revised code.
- The content from the ethics ruling, "Financial Services Company Client Has Custody of a Member's Assets" (ET sec. 191.081-.082) is incorporated into the "Brokerage and Other Accounts" interpretation (ET sec. 1.255.020), found under the subtopic "Depository, Brokerage, and Other Accounts" (ET sec. 1.255) of the "Independence" topic (ET sec. 1.200).

The revised code was effective December 15, 2014, and is available at <http://pub.aicpa.org/codeofconduct/ethics.aspx>. References to the code have been updated in this guide. To assist users in locating the revised code content from the prior code, PEEC created a mapping document. The mapping document is available in Excel format in appendix D in the revised code.

TABLE OF CONTENTS

Chapter		Paragraph
1	The Use of Analytical Procedures	.01-.48
	Concepts and Definitions .....	.03-.13
	Analytical Procedures .....	.03-.09
	Expectations .....	.10
	Precision .....	.11-.12
	Level of Assurance .....	.13
	Analytical Procedure Process: Four Phases .....	.14-.48
	Expectation Formation (Phase I) .....	.16-.40
	Identification and Investigation (Phases II and III) .....	.41-.46
	Evaluation (Phase IV) .....	.47-.48
2	Questions and Answers	.1-.42
	Precision of the Expectation .....	.02-.15
	Relationship of Analytical Procedures to the Audit Risk Model .....	.16-.23
	Evaluation and Investigation .....	.24-.28
	Purpose of Analytical Procedures .....	.29-.39
	Fraud .....	.40-.42
Appendix		
A	Case Study: On the Go Stores	
B	Measures of Precision for a Regression Analysis	
C	Financial Ratios	
D	Overview of Statements on Quality Control Standards	
E	Schedule of Changes Made to the Text From the Previous Edition	
Index of Pronouncements and Other Technical Guidance		
Subject Index		

Chapter 1

The Use of Analytical Procedures

1.01 This chapter discusses the concepts and definitions found in AU-C section 520, *Analytical Procedures* (AICPA, *Professional Standards*). Also discussed are the four phases of the analytical procedure process: expectation formation, identification, investigation, and evaluation.

1.02 Analytical procedures are a natural extension of the auditor's understanding of the client's business and add to his or her understanding because the key factors that influence the client's business may be expected to affect the client's financial information. Analytical procedures are used in all three stages of the audit. In the planning stage, the purpose of analytical procedures is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain audit evidence for specific account balances or classes of transactions.¹ In the substantive testing stage of the audit, the purpose of analytical procedures is to obtain evidence, sometimes in combination with other substantive procedures, to identify misstatements in account balances, and thus to reduce the risk that misstatements will remain undetected. The auditor's reliance on substantive tests to achieve an audit objective related to a particular assertion may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedure or procedures to use to achieve a particular audit objective is based on the auditor's judgment about the expected effectiveness and efficiency of the available procedures. In the overall review stage, the objective of analytical procedures is to assist the auditor in assessing the conclusions reached and in evaluating the overall financial statement presentation.

Concepts and Definitions

Analytical Procedures

1.03 Analytical procedures are defined by paragraph .04 of AU-C section 520 as "evaluations of financial information through analysis of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass such investigation, as is necessary, of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount." The definition implies several key concepts:

- The "evaluations of financial information" suggests that analytical procedures will be used to understand or test financial statement relationships or balances.
- The "investigation...of identified fluctuations or relationships that are inconsistent with other relevant information or that differ

¹ In accordance with paragraph .06 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), analytical procedures should be performed as risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. Refer to AU-C section 315 for further guidance.

from expected values by a significant amount" implies an understanding of what can reasonably be expected and involves a comparison of the recorded book values with an auditor's expectations and an understanding of those differences.

- "Relationships among both financial and nonfinancial data" suggests that both types of data can be useful in understanding the relationships of the financial information and, therefore, in forming an expectation.

1.04 AU-C section 520 addresses the auditor's use of analytical procedures as substantive procedures (substantive analytical procedures). It also addresses the auditor's responsibility to perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements. Analytical procedures also are used as risk assessment procedures (which may be referred to as analytical procedures used to plan the audit), as described in AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, (AICPA, *Professional Standards*). AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), also addresses the use of analytical procedures as substantive procedures. In all cases, the effectiveness of analytical procedures lies in developing expectations that can reasonably be expected to identify unexpected relationships. Paragraph .08 of AU-C section 520 provides requirements for documentation of the performance of substantive analytical procedures. If an analytical procedure is used as the principal substantive test of a significant financial statement assertion, the auditor should document all of the following:

- a. The expectation referred to in paragraph .05c of AU-C section 520 and the factors considered in its development when that expectation or those factors are not otherwise readily determinable from the audit documentation
- b. Results of the comparison referred to in paragraph .05d of AU-C section 520 of the recorded amounts, or ratios developed from recorded amounts, with the expectations
- c. Any additional auditing procedures performed in accordance with paragraph .07 of AU-C section 520 relating to the investigation of fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount and the results of such additional procedures

1.05 Also, in accordance with paragraphs .06b and .A7–.A9 of AU-C section 315, the auditor should apply analytical procedures on the planning stage of the audit. Those procedures may provide useful information in planning the audit to assist in understanding the entity and its environment and to identify areas that may represent specific risks relevant to the audit. For example, analytical procedures may be helpful in identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit implications. In performing analytical procedures as risk assessment procedures, the auditor should develop expectations about plausible relationships that are reasonably expected to exist. When comparison of those expectations with recorded amounts or ratios developed from recorded amounts yields unusual or unexpected relationships, the auditor should consider those results in identifying risks of material misstatement. However, when such analytical procedures use data aggregated at a high

level (which is often the situation), the results of those analytical procedures provide only a broad initial indication about whether a material misstatement may exist. Accordingly, the auditor should consider the results of such analytical procedures along with other information gathered in identifying the risks of material misstatement.

1.06 Analytical procedures performed when forming an overall conclusion about whether the financial statements are consistent with the auditor's understanding of the entity are designed to assist the auditor in assessing (a) the adequacy of the evidence gathered in response to unusual or unexpected balances identified during the course of the audit and (b) all significant fluctuations and other unusual items have been adequately identified and explained.

1.07 During the substantive testing stage, analytical procedures may be used to obtain assurance that material misstatements are not likely to exist in financial statement account balances. If analytical procedures are used for substantive testing, the auditor should focus his or her analytical procedures on relevant assertions related to each material class of transactions, account balance, and disclosure and should give detailed attention to the underlying factors that affect those areas through the development of an expectation independent of the recorded balance. Therefore, substantive analytical procedures generally are performed with more rigor and precision than those used for planning or overall review.

1.08 Paragraph .05 of AU-C section 520 contains requirements when designing and performing analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with AU-C section 330. The auditor should

- a. determine the suitability of particular substantive analytical procedures for given assertions, taking into account the assessed risks of material misstatement and tests of details, if any, for these assertions;
- b. evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking into account the source, comparability, and nature and relevance of information available and controls over preparation;
- c. develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise (taking into account whether substantive analytical procedures are to be performed alone or in combination with tests of details) to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and
- d. determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph .07 of AU-C 520 and compare the recorded amounts, or ratios developed from recorded amounts, with the expectations.

When evaluating the reliability of the data, as required in paragraph .05b of AU-C section 520, the auditor could test the controls, if any, over the entity's preparation of information to be used by the auditor in applying analytical procedures. When such controls are effective, the auditor has greater confidence in the reliability of the information and, therefore, in the results of analytical

procedures. When designing substantive analytical procedures, the auditor should evaluate whether the controls that are in place are operating effectively, including the risk of management override of controls. As part of this process, the auditor might need to evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting some types of fraud. Alternatively, the auditor may consider whether the information was subjected to audit testing in the current or prior period. In determining the audit procedures to apply to the information upon which the expectation for substantive analytical procedures is based, the auditor should consider the guidance in paragraphs .07–.10 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), as it relates to the relevance and reliability of the information.

1.09 In planning substantive analytical procedures, the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced primarily by performance materiality and should be consistent with the desired level of assurance. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balance, class of transactions, or disclosure could aggregate to an unacceptable amount. In designing substantive analytical procedures, the auditor should increase the desired level of assurance as the risk of material misstatement increases.

Expectations

1.10 Expectations are the auditor's predictions of recorded accounts or ratios. In performing analytical procedures, the auditor should develop the expectation in such a way that a significant difference between it and the recorded amount is indicative of a misstatement, unless he or she can obtain and corroborate explanations for the difference (for example, an unusual event occurred). Expectations are developed by identifying plausible relationships (for example, store square footage and retail sales) that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. The auditor may select from a variety of data sources to form expectations. For example, the auditor may use prior-period information (adjusted for expected changes), management's budgets or forecasts, industry data, or nonfinancial data. The source of information determines, in part, the precision with which the auditor predicts an account balance and, therefore, is important to consider in developing an expectation to achieve the desired level of assurance from the analytical procedure.

Precision

1.11 Precision is a measure of the closeness of the auditor's expectation to the correct amount. The desired precision of the expectation varies according to the stage of the audit or the purpose of the analytical procedure. For example, precision is more important for analytical procedures used as substantive tests than for those used in planning. The effectiveness of analytical procedures depends on their precision and purpose. Factors that affect the precision of analytical procedures include

- the type of expectation developed.
- the reliability and other characteristics of the data used in forming the expectation (both internally and externally prepared data).
- the nature of the account or the assertion.

1.12 For example, an auditor plans to test interest income. Because the nature of the account is relatively objective (interest income can easily be predicted), analytical procedures could be designed to serve as an effective substantive test. If the auditor needs a high level of assurance from a procedure, he or she should develop a relatively precise expectation by selecting the appropriate type of expectation (for example, a reasonableness test instead of a simple trend analysis), the level of detail of the data (for example, quarterly versus annual data), and the reliability of the source of the data (for example, data that have been subject to auditing procedures versus data that have not been subject to auditing procedures). In the case of substantive tests, the precision of the expectation is the primary determinant of the level of assurance obtained from the analytical procedure. It affects the ability of the auditor to identify correctly whether a given unexpected difference in an account balance is the result of a misstatement. Because precision is directly related to the level of assurance obtained, it is an important consideration in determining whether the planned level of assurance desired from the analytical procedure is achieved. In addition, the higher the desired levels of assurance, the more precise the expectation would need to be.

Level of Assurance

1.13 Level of assurance is the complement of the level of detection risk and is the degree to which substantive auditing procedures (including analytical procedures) provide evidence in testing an assertion. The level of assurance is dependent on the restriction of detection risk because inherent and control risk exist independently of an audit of financial statements. Detection risk relates to the auditor's procedures and can be changed at his or her discretion. The desired or planned level of assurance is that level needed to achieve an acceptable level of detection risk. It is determined by the acceptable level of audit risk, the risk of material misstatement (in other words, the combined assessment of inherent and control risk), and the planning materiality threshold. The achieved level of assurance is the degree to which the auditing procedure actually reduces audit risk and is a function of the effectiveness of the substantive procedures.

Analytical Procedure Process: Four Phases

1.14 The use of analytical procedures can be considered a process that consists of four phases. The first phase is the expectation-formation process. In this phase, the auditor forms an expectation of an account balance or financial relationship. In doing so, the auditor determines the precision of the expectation and thus, in part, the effectiveness of the analytical procedure.

1.15 The remaining three phases consist of the identification, investigation, and evaluation of the difference between the auditor's expected value and the recorded book value in light of the auditor's materiality assessment. In the second phase, identification, the auditor identifies whether an unusual fluctuation exists between the expected and recorded amounts. In the third, investigation, the auditor investigates the cause of unexpected differences by

considering possible causes and searching for information to identify the most probable causes. Finally, in the evaluation phase, the auditor evaluates the likelihood of material misstatement and determines the nature and extent of any additional auditing procedures that may be required.

Expectation Formation (Phase I)

1.16 Forming an expectation is the most important phase of the analytical procedure process. The more precise the expectation (that is, the closer the auditor's expectation is to the correct balance or relationship), the more effective the procedure will be at identifying potential misstatements. Also, paragraph .05c of AU-C section 520 states that the expectation should be precise enough to provide the desired level of assurance that differences that may be potential misstatements, individually or when aggregated with other misstatements, would be identified for the auditor to investigate.

1.17 The effectiveness of an analytical procedure is a function of three factors related to the precision with which the expectation is developed: (a) the nature of the account or assertion, (b) the reliability and other characteristics of the data, and (c) the inherent precision of the expectation method used. Following is a discussion about each of these factors.

Nature of the Account or Assertion

1.18 Analytical procedures are based on relationships between data (see appendix B, "Measures of Precision for a Regression Analysis," of this guide), for example, how this year compares with last and how amounts on a balance sheet relate to income and expense items. The more predictable the relationships are, the more precise the expectation will be. The following are factors an auditor may consider in predicting the amount of an account:

- The subjective or objective nature of the items in an account balance (for example, whether the account comprises estimates or the accumulation of transactions)
- Product mix
- Company profile (for example, the number of stores or the various locations)
- Management's discretion (for example, estimates)
- Stability of the environment
- Income statement or balance sheet account

1.19 Numerous factors affect the amount of an account balance. Increasing the number of such factors considered in forming an expectation of the account balance increases the precision of the expectation. Such factors include

- significant events.
- accounting changes.
- business and industry factors.
- market and economic factors.
- management incentives.
- initial versus repeat engagement.

1.20 Moreover, expectations developed for income statement accounts tend to be more precise than expectations for balance sheet accounts because

income statement relationships generally are more predictable. In addition, expectations formed under stable economic conditions (for example, stable interest rates) or stable environmental factors (for example, no regulatory changes) tend to be more precise relative to an unstable economy or environment.

Reliability and Other Characteristics of the Data

1.21 In forming an expectation, an auditor should consider two broad factors related to the characteristics of the data included in the account: the level of detail on which the auditor is able to base his or her expectation and the reliability of the data.

1.22 In general, the more disaggregated the data, the more precise the expectation. For example, the use of monthly instead of annual data tends to improve the precision of the expectation. Preparing an expectation by store or division is also more precise than an expectation based on consolidated data.

1.23 The more reliable the source of the data, the more precise the expectation. The following are factors related to the reliability of data that the auditor may consider in forming the expectation:

- *Strength of the company's internal control.* The stronger the internal control over financial reporting (which includes controls over the accounting system), the more reliable the data generated from the company's accounting system.
- *Outside versus internal data and degree of independence.* Data from more objective or independent sources are more reliable (for example, third-party generated versus management generated).
- *Nonfinancial versus financial data or data that has been subject to auditing procedures versus data that has not been subject to auditing procedures.* The use of reliable nonfinancial data (for example, store square footage or occupancy rates) and the use of data that has been subjected to auditing procedures improve the precision of the expectation.

1.24 The auditor should assess the reliability of data used to develop his or her expectations, taking into account, if necessary, the results of other related procedures. When substantive analytical procedures are used to test for both overstatement and understatement, the auditor needs to ensure that the data used to build the expectation is reliable in both directions.

Inherent Precision of the Expectation Method Used

1.25 Expectations can be developed with methods as simple as using the prior-year sales balance (adjusted for expected changes) as the expectation for current year sales or as complex as multiple regression analysis that incorporates both financial (for example, cost of goods sold) and nonfinancial data (for example, store square footage) to predict retail sales. The auditor typically selects the most appropriate type of expectation method to use for an account by considering the level of assurance desired for the procedure. Determining which type of expectation method is appropriate is a matter of professional judgment; however, the inherent precision of the expectation method used is a consideration in developing the expectation. The four types of expectation methods and their appropriateness are discussed in the following paragraphs.

1.26 *Trend analysis.* This is the analysis of changes in an account balance over time. Simple trends typically compare last year's account balance to the current unaudited balance. More sophisticated trends encompass multiple time periods.

1.27 Trend analysis is most appropriate when the account or relationship is fairly predictable (for example, sales in a stable environment). It is less effective when the entity under audit has experienced significant operating or accounting changes. The number of years used in the trend analysis is a function of the stability of operations. The more stable the operations over time, the more predictable the relations and the more appropriate the use of multiple time periods.

1.28 Trend analysis at an aggregate level (for example, trend analysis of an entity's operating units on a consolidated basis) is relatively imprecise because a material misstatement is often small relative to the natural variation in an aggregate account balance. This suggests the need to perform trend analysis on a disaggregated level (for example, by segment, product, or location, and monthly or quarterly rather than on an annual basis).

1.29 In using trend analysis, it is important for the auditor to understand the volatility of the environment related to the accounts being tested. For example, research has shown that, except in situations in which the environment has remained stable relative to the prior year, using only the prior-year balance as the expectation reduces the effectiveness of analytical procedures to identify potential high-risk areas. In fact, using only the prior-year balance without considering whether it is the most appropriate expectation can lead to a bias toward accepting the current data that have not been subject to auditing procedures as fairly stated, even when they are misstated.

1.30 *Ratio analysis.* This is the comparison of relationships between financial statement accounts (between two periods or over time), the comparison of an account with nonfinancial data (for example, revenue per order or sales per square foot), or the comparison of relationships between firms in an industry (for example, gross profit comparisons). Ratio analysis entails a comparison of interrelations between accounts, nonfinancial information, or both. Another example of ratio analysis (which is sometimes referred to as common size analysis) is the comparison of the ratio of shipping costs or other selling expenses to sales from the prior year with the current year ratio, or the comparison of shipping costs to sales with the ratio for a comparable firm in the same industry. See appendix C, "Financial Ratios," of this guide for a listing of helpful ratios.

1.31 Ratio analysis is most appropriate when the relationship between accounts is fairly predictable and stable (for example, the relationship between sales and accounts receivable). Ratio analysis can be more effective than trend analysis because comparisons between the balance sheet and income statement can often reveal unusual fluctuations that an analysis of the individual accounts would not. Comparison of ratios with industry averages (or with comparable firms in the same industry) is most useful when operating factors are comparable.

1.32 Ratio analysis at an aggregate level (that is, consolidated operating units or across product lines) is relatively imprecise because a material misstatement is often small relative to the natural variations in the ratios. This suggests the need to perform ratio analysis on a disaggregated level (for example, by segment, product, or location).

1.33 Reasonableness testing. This is the analysis of account balances or changes in account balances within an accounting period that involves the development of an expectation based on financial data, nonfinancial data, or both. For example, an expectation for hotel revenues may be developed using the average occupancy rate, the average room rate for all rooms, or room rate by category or class of room. Also, using the number of employees hired and terminated, the timing of pay changes, and the effect of vacation and sick days, the model could predict the change in payroll expense from the previous year to the current balance within a fairly narrow dollar range.

1.34 In contrast to both trend and ratio analyses (which implicitly assume stable relationships), reasonableness tests use information to develop an explicit prediction of the account balance or relationship of interest. Reasonableness tests rely on the auditor's knowledge of the relationships, including knowledge of the factors that affect the account balances. The auditor uses that knowledge to develop assumptions for each of the key factors (for example, industry and economic factors) to estimate the account balance. A reasonableness test for sales could be explicitly formed by considering the number of units sold, the unit price by product line, different pricing structures, and an understanding of industry trends during the period. This is in contrast to an implicit trend expectation for sales based on last year's sales. The latter expectation is appropriate only if there were no other factors affecting sales during the current year, which is not the usual situation.

1.35 Regression analysis. This is the use of statistical models to quantify the auditor's expectation in dollar terms, with measurable risk and precision levels.² For example, an expectation for sales may be developed based on management's sales forecast, commission expense, and changes in advertising expenditures.

1.36 Regression analysis is similar to reasonableness testing in that there is an explicit prediction using the auditor's knowledge of the factors that affect the account balances to develop a model of the account balance. The model is most effective when the data are disaggregated and are from an accounting system with effective internal controls.

Relationship Between the Methods Used to Develop an Expectation and the Precision of the Expectation

1.37 Of the four types of expectation methods, trend analysis generally provides the least precision because this expectation method does not take into consideration changes in specific factors that affect the account (for example, product mix). The imprecision is magnified in the context of a changing environment in which the assumptions underlying the prior year numbers are no longer valid. For example, the auditor is predicting sales and new products have been introduced, or economic conditions affecting sales have changed significantly. Using prior year's sales (or an average of the time series) as the implicit expectation for current sales does not provide a precise expectation because it

² In many cases, the client has developed analytical procedures, internal models, or both for monitoring and evaluating its business and performance. The auditor may find these internal analytics useful for developing his or her own analytical procedures in the planning phase of an audit and substantive testing purposes.

omits relevant information about additional products and changes in the economic environment.³

1.38 Regression analysis, in contrast, provides potentially the highest level of precision because an explicit expectation is formed in which the relevant data can be incorporated in a model to predict current year sales. Regression analysis potentially can take into account all of the relevant operating data (sales volume by product), changes in operations (changes in advertising levels, changes in product lines or product mix), and changes in economic conditions. In addition, regression analysis allows the auditor to measure the precision of the expectation.

1.39 The precision of ratio analysis and reasonableness testing typically falls somewhere in between that of trend analysis and regression analysis. However, reasonableness tests generally provide better precision because they involve the formation of explicit expectations similar to regression analysis. That is, reasonableness tests can employ multiple sources of data, both financial and nonfinancial, across time. Ratio analysis is similar to trend analysis in that it employs an implicit expectation. That is, when using a reasonableness test, the auditor may begin with the idea of predicting the balance, whereas for ratio analysis, the expectation formation process is implicit—as the ratio is compared with budget, industry, or other relevant benchmarks.

1.40 Some aspects of the foregoing analysis can be summarized and grouped according to a number of factors, as follows:

- *Explicit or implicit expectation.* When using reasonableness tests or regression, the auditor is explicitly forming an expectation. This approach helps to increase the precision of the expectation. In contrast, in using trend and ratio analysis the auditor may tend to rely more upon comparison and evaluation, for example, to budget, prior year, or industry figures that may or may not be relevant due to changes in the entity's operations or in the economic environment affecting the entity or its specific industry.
- *Number of predictors.* Trend analysis is limited to a single predictor, that is, the prior period's or periods' data for that account. Because ratio analysis employs two or more related financial or nonfinancial sources of information, thus using known relationships among the accounts, the result is a more precise expectation. Reasonableness tests and regression analysis further improve the precision of the expectation by allowing potentially as many variables (financial and nonfinancial) as are relevant for forming the expectation.
- *Operating data.* Trend analysis, by relying on a single predictor, does not allow the use of potentially relevant operating data, as do the other three types of procedures.
- *External data.* Reasonableness tests and regression analysis are able to use external data (for example, general economic and industry data) directly in forming the expectation. Although external data can potentially be used in ratio analysis, its use in this manner is quite rare.

³ This discussion is not intended to suggest that trend analysis is imprecise or that it cannot be improved to be more precise. For example, changing interest rates, inflation, or price changes can be incorporated or factored into trend analysis to increase the analytical procedure's precision.

- *Statistical power.* Of the four expectation methods described herein, only regression analysis provides the benefits of statistical precision. The statistical model provides not only a best expectation given the data at hand, but also provides quantitative measures of the fit of the model.

Table 1-1 illustrates how the four expectation methods differ in terms of the five criteria in the previous list for determining the most appropriate method.

Table 1-1

The Relationship Between Types of Analytical Procedures and Selected Precision Factors

<i>Type of Analytical Procedure</i>	<i>Explicit or Implicit Expectation</i>	<i>Number of Predictors</i>	<i>Can Include Operating Data</i>	<i>Can Include External Data</i>	<i>Measure of Statistical Precision</i>
Trend Analysis	Implicit	One	No	No	No
Ratio Analysis	Implicit	Two	Yes	Limited	No
Reasonableness Test	Explicit	Two or more	Yes	Yes	No
Regression Analysis	Explicit	Two or more	Yes	Yes	Yes

Identification and Investigation (Phases II and III)

1.41 The next two phases of the analytical procedure process consist of identification and investigation. Identification begins by comparing the auditor's expected value with the recorded amount. Given that the auditor developed an expectation with a particular amount of difference that could be accepted without further explanation, he or she then compares the unexpected differences with the threshold. In substantive testing, an auditor testing for the possible misstatement of the book value of an account determines whether the audit difference was less than the auditor's threshold. If the difference is less than the acceptable threshold, taking into consideration the desired level of assurance from the procedure, the auditor accepts the book value without further investigation. If the difference is greater, the next step is to investigate the difference.

1.42 In investigation, the auditor should evaluate possible explanations for the difference. The greater the precision of the expectation (that is, the closer the expectation is to the correct amount), the greater the likelihood that the difference between the expected and recorded amounts is due to misstatement rather than non-misstatement causes. The difference between an auditor's expectation and the recorded book value of an account (value of an account not subject to auditing procedures) can be due to any or all of the following three causes: (a) the difference is due to misstatements, (b) the difference is due to inherent factors that affect the account being audited (for example, the predictability of the account or account subjectivity), and (c) the difference is due to factors related to the reliability of data used to develop the expectation (for example, data that have been subject to auditing procedures versus data that

have not been subject to auditing procedures). The greater the precision of the expectation, the more likely the difference between the auditor's expectation and the recorded value will be due to misstatements (cause *a*). Conversely, the less precise the expectation, the more likely the difference is due to factors related to the precision of the expectation (causes *b* and *c*).

1.43 If the auditor believes that the difference is more likely due to factors related to the precision of the expectation, the auditor should consider whether a more precise expectation can be cost-effectively developed. If so, the analytical procedure should be reperformed based on the new expectation, and the new difference should be calculated. On the other hand, the auditor may rule out causes *b* and *c* (see paragraph 1.42) as explanations for the unexpected difference and may then evaluate the unexpected difference as a potential misstatement. The auditor should then perform further analysis and inquiry to evaluate the most likely causes and identify a plausible explanation.

1.44 Plausible explanations usually relate to unusual transactions or events or accounting or business changes. In evaluating whether an explanation is plausible, the auditor might consider such factors as

- the understanding of matters noted while performing audit work in other areas, particularly while performing audit work on the data used to develop the expectation.
- management and board reports containing explanations of significant variances between budgeted and actual results.
- review of board minutes.
- information on unusual events occurring in prior years (this may indicate the types of unusual events that could have affected the current year data).

1.45 When analytical procedures serve as substantive tests, the auditor should ordinarily corroborate explanations for significant differences by obtaining sufficient appropriate audit evidence. The procedures used to corroborate the explanation depend on the nature of the explanation, the nature of the account balance, and the results of other substantive procedures. To corroborate an explanation, one or more of the following techniques may be used:

- *Inquiries of persons outside the client's organization.* For example, the auditor may confirm discounts received with major suppliers or agree to changes in commodity prices with a commodities exchange or the financial press.
- *Inquiries of independent persons inside the client's organization.* For example, an explanation received from the financial controller for an increase in advertising expenditures might be corroborated with the marketing director. It is normally inappropriate to corroborate explanations only by discussion with other accounting department personnel.
- *Evidence obtained from other auditing procedures.* Sometimes the results of other auditing procedures (particularly those performed on the data used to develop an expectation) are sufficient to corroborate an explanation.
- *Examination of supporting evidence.* The auditor may examine supporting documentary evidence of transactions to corroborate explanations. For example, if an increase in cost of sales in one

month was attributed to an unusually large sales contract, the auditor might examine supporting documentation, such as the sales contract and delivery dockets.

1.46 When the population is disaggregated, a pattern in the differences may indicate that there is a common explanation for those differences. However, the auditor cannot assume that this is the case. He or she should perform sufficient work to corroborate each significant difference.

Evaluation (Phase IV)

1.47 The final phase of the analytical procedure process consists of evaluating the difference between the auditor's expected value and the recorded amount. It is usually not practicable to identify factors that explain the exact amount of a difference identified for investigation. However, the auditor should attempt to quantify that portion of the difference for which plausible explanations can be obtained and, where appropriate, corroborated and determine that the amount that cannot be explained is sufficiently small to enable him or her to conclude on the absence of material misstatement.

1.48 If a reasonable explanation cannot be obtained, in accordance with paragraph .11 of AU-C section 450, *Evaluation of Misstatements Identified During the Audit* (AICPA, *Professional Standards*), the auditor should determine whether uncorrected misstatements are material, individually or in the aggregate. In making this determination, the auditor should consider (a) the size and nature of the misstatements, both in relation to particular classes of transactions, account balances, or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence and (b) the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances, or disclosures and the financial statements as a whole.

Chapter 2

Questions and Answers

2.01 This chapter provides questions and answers relating to analytical procedures. The questions and answers are grouped in the following five categories: precision of the expectation, relationship of analytical procedures to the audit risk model, evaluation and investigation, purpose of analytical procedures, and fraud.

Precision of the Expectation

2.02 Question 1: What factors are important in determining the level of assurance provided by an analytical procedure?

2.03 Answer: The level of assurance provided by an analytical procedure is determined by the precision of the expectation. The higher the precision, the greater the level of assurance provided by the procedure. The factors affecting the precision of an expectation are (a) the nature of the account or assertion (for example, its predictability or subjectivity), (b) the characteristics of the data including the level of disaggregation of the data and the availability, sources, and reliability of the data, and (c) the inherent precision of the type of expectation formed (trend or ratio analysis, reasonableness test, or regression analysis).

2.04 Question 2: How does the aggregation of data affect the level of assurance provided by an analytical procedure?

2.05 Answer: Data aggregation refers to the level at which account balances are combined for testing (for example, account balances on an annual instead of a quarterly basis or the consolidation of operating units). Generally, the more disaggregated the data used to form the expectation, the more precise that expectation will be. This will result in a higher level of assurance that material misstatement will be detected. Disaggregation is typically more important when the entity's operations are more complex or diversified. However, the auditor should assess the reliability of disaggregated data. For example, certain quarterly data may be less reliable than annual data because it is unaudited or is not subject to the same controls as the annual data. The auditor should use judgment in determining which precision factor is more important in the circumstances. (See the case study in appendix A, "Case Study: On the Go Stores," of this guide and in paragraph .05 of AU-C section 520, *Analytical Procedures* [AICPA, *Professional Standards*].)

2.06 Question 3: Does the reliability of the data used in forming an expectation affect the level of assurance provided by the analytical procedure?

2.07 Answer: One of the factors affecting the precision of the expectation, and thus the level of assurance, is the reliability of the data sources used to develop the expectation. For example, data that have been subject to auditing procedures are more likely to be reliable than data that have not. If the data are produced by the entity's financial reporting system, the auditor should assess the level of control risk in assessing data reliability (see question 9). If the data are produced by another reporting system within the entity outside the financial reporting function, the auditor should assess the manner in which the data are developed and reviewed by management. If the data are produced

outside the entity, the auditor should assess the objectivity of the source (for example, the independence of the publisher of the data from the intended users of the data) and the manner in which they were developed. Examples of matters to consider when evaluating data produced outside the entity include (a) the existence of a defined set of measurement criteria, (b) observed flaws in previous publications of similar reports, and (c) the general acceptance of the data source. For example, statistics published by the U.S. Department of Labor are more likely to be reliable than similar statistics provided by an industry trade group.

2.08 Question 4: What is the role of planning materiality in determining the desired precision of an expectation in testing an account balance?

2.09 Answer: Planning materiality is an indication of the amount of misstatement in the financial statements that an auditor is willing to accept. Planning materiality, in part, determines the level of assurance that the auditor expects to obtain from the audit procedure. Because the precision of the expectation directly affects the level of assurance, the auditor should consider materiality when determining how precise an expectation needs to be to detect misstatements that, in the aggregate, exceed materiality. An inverse relationship exists between the precision of the expectation and planning materiality. Holding all other factors constant, as planning materiality decreases, the expectation becomes more precise to achieve the same level of assurance.

2.10 Question 5: When is it beneficial to form expectations for substantive tests using regression analysis?

2.11 Answer: When using regression analysis as a substantive audit procedure, it is not necessary to develop an expectation beyond identifying a potential relationship between the dependent and independent variables (for example, an increase in both the number of working hours and the level of advertising expenditure will lead to an increase in revenue). The advantage of regression analysis over other methods is that regression analysis provides an explicit, mathematically objective, and precise method of forming an expectation; allows the inclusion of a larger number of relevant independent variables; and provides a direct and quantitative measure of the precision of the expectation.

2.12 Question 6: When is it appropriate to perform substantive tests using ratio or trend analysis and reasonableness tests?

2.13 Answer: Ratio and trend analysis are often used in audit planning. However, when plausible and predictable relationships exist between the data used to form the expectation and the balance to be tested, and the data are reliable and disaggregated, ratio and trend analyses can be effective substantive tests. Generally, ratio and trend analyses are relatively imprecise and should be performed at a disaggregated level when higher levels of assurance are desired. Reasonableness tests often are used in testing account balances, particularly estimates, by forming expectations based on financial or nonfinancial data. If a high level of assurance is desired from a reasonableness test (for example, to test a detailed transaction), the auditor often reconstructs or recomputes the balance.

2.14 Question 7: What are the differences, if any, between expectation formation for analytical procedures used during planning, substantive testing, and the overall review stages of the audit?

2.15 Answer: Precision of the expectation is the most important factor in determining the level of assurance the analytical procedure provides. When performing analytical procedures during planning, the primary focus is to identify unexpected changes or the absence of expected changes that may indicate a risk of material misstatement. The purpose of those procedures is to assist in determining the nature, timing, and extent of substantive procedures. As a result, the expectations can be less precise, and the analysis and investigation of unexpected changes can be less extensive. In contrast, when performing analytical procedures as substantive tests, the desired level of assurance is higher than that of the planning stage; therefore, expectations of the recorded amounts should be more precise, because the procedures performed are to directly identify misstatements in the account balances being tested. When performing analytical procedures in the overall review stage of the audit, the focus is on assisting the auditor in assessing the conclusions reached as a result of substantive testing and in evaluating the overall financial statements. As a result, in the overall review stage the expectations developed are not as precise as those developed in performing substantive tests.

Relationship of Analytical Procedures to the Audit Risk Model

2.16 Question 8: How does the auditor's assessment of inherent risk affect the auditor's decision to use analytical procedures and the level of assurance provided by those procedures?

2.17 Answer: The influence of inherent risk on the auditor's decision to use analytical procedures, and the assurance provided from them, is dependent on the extent to which inherent risk affects the precision of the auditor's expectation. As noted in question 1, the nature of the account and the environment (factors affecting inherent risk) affect the precision of the expectation. The more susceptible an assertion is to misstatement (absent related internal control) and the less predictable the account, the higher the inherent risk and the less precise an expectation will necessarily be, thereby reducing the amount of audit evidence to be obtained from performing the analytical procedure. Auditors should exercise professional judgement in determining the combination of audit procedures to perform in order to obtain sufficient appropriate audit evidence.

2.18 Question 9: When auditing an account that represents a significant risk, can an auditor rely only upon the evidence obtained from the performance of analytical procedures alone?

2.19 Answer: No. Paragraph .22 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states that when the approach to a significant risk consists only of substantive procedures, those procedures should include tests of details.

2.20 Question 10: How does the assessment of control risk affect an auditor's decision to use analytical procedures and the level of assurance provided by those procedures?

2.21 Answer: The influence of control risk on the auditor's decision to use analytical procedures, and the assurance provided from them, are dependent on the extent to which control risk affects the precision of the expectation. Control

risk is directly related to data reliability. In addition, data reliability directly affects expectation precision. Therefore, if financial data produced by the entity are used in developing the expectation and the auditor wishes to form a precise expectation, he or she should take steps to determine that the data used in developing the expectation are reliable. However, this does not preclude the auditor from performing analytical procedures when the operating effectiveness of the control has not been tested.

2.22 Question 11: When assessing the risks of material misstatement in planning a sample for a substantive test of details (statistical or nonstatistical), can the results of analytical procedures be used as a factor in determining the sample size?

2.23 Answer: The use of analytical procedures may help inform the auditor's assessment of the risks of material misstatement. Risk assessment then influences the level of assurance that the auditor desires to obtain from a sample for a substantive test of details. The auditor should refer to the AICPA Audit Guide *Audit Sampling* for detailed guidance on the use of sampling.

Evaluation and Investigation

2.24 Question 12: When does the auditor perform further investigation based upon the findings of an analytical procedure?

2.25 Answer: When a difference between the auditor's expectation and the recorded amount exceeds the amount of difference from the expectation that can be accepted without further explanation, the auditor should identify and consider plausible explanations for the difference. The determining factor to such a consideration is the precision of the expectation. If the auditor concludes that the expectation is so precise that the range of expected differences is sufficiently narrow, the auditor might conclude that the difference between the expectation and the recorded amount represents a misstatement of the account balance. Further analysis involves determining whether all the relevant factors were considered in developing the expectation (that is, was the expectation sufficiently precise to achieve the desired level of assurance). Plausible explanations arising from failing to consider all relevant factors usually relate to unusual transactions or events or to accounting or business changes. If the auditor rules out other plausible, non-misstatement explanations for the difference, the auditor should then further investigate for misstatement causes.

2.26 In establishing the amount of difference from the expectation that can be accepted without further explanation, the auditor considers not just the magnitude of an individual difference, but also the effect such a difference would have when aggregated with other audit differences.

2.27 Question 13: How does the auditor evaluate differences in excess of the auditor's threshold between the expected and recorded amounts?

2.28 Answer: If the difference between expected and recorded amounts is likely due to potential misstatement, the auditor should perform further analysis and inquiry. (See the "Identification and Investigation" and "Evaluation" sections of chapter 1, "The Use of Analytical Procedures," for situations in which the unexpected difference is not due to a misstatement.) The auditor should obtain sufficient appropriate evidence by performing other audit procedures and inquiring of management about the difference between the expectation formed and the recorded amount. Considering possible explanations

for the difference before inquiring of management will likely improve the accuracy of the evaluation of the difference. If a reasonable explanation cannot be obtained, in accordance with paragraph .11 of AU-C section 450, *Evaluation of Misstatements Identified During the Audit* (AICPA, *Professional Standards*), the auditor should determine whether uncorrected misstatements are material, individually or in the aggregate. In making this determination, the auditor should consider (a) the size and nature of the misstatements, both in relation to particular classes of transactions, account balances, or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence and (b) the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances, or disclosures and the financial statements as a whole.

Purpose of Analytical Procedures

2.29 Question 14: Can analytical procedures provide evidence about the effectiveness of internal control over financial reporting?

2.30 Answer: Yes. The results of a substantive analytical procedure can, in certain situations, provide evidence about the effectiveness of internal control over financial reporting. If the auditor was to identify a misstatement as a result of the performance of a substantive analytical procedure, the misstatement would likely be indicative of either the absence of a relevant control or the failure of a control to perform properly. However, as stated in paragraph .16 of AU-C section 330, the absence of misstatements detected by substantive procedures does not provide audit evidence that controls related to the relevant assertion being tested are effective.

2.31 Question 15: What are the differences, if any, between substantive analytical procedures performed in an audit, a review, and an attest engagement?

2.32 Answer: The primary difference in analytical procedures performed in an audit versus a review is the desired level of assurance. In an audit, the substantive analytical procedures performed are designed to provide assurance that the financial statements are fairly presented. In a review, the analytical procedures are performed in connection with inquiries of management to provide limited assurance that the accountant is not aware of any material misstatements. An auditor requires a more precise expectation in an audit than in a review because the audit requires a higher level of assurance.

2.33 This concept also applies when performing analytical procedures in an attest engagement related to financial matters (for example, examination of pro forma financial information). If the accountant performs an examination of management's assertion and performs analytical procedures to provide a high level of assurance, a practitioner requires a more precise expectation than if the practitioner is to provide limited assurance under a review.

2.34 Question 16: What is the role of analytical procedures in planning when the auditor knows from past experience that numerous adjustments are posted to the working trial balance during the engagement?

2.35 Answer: In planning the audit, the auditor should perform analytical procedures that assist in understanding the client's business and material classes of transactions and in determining the nature, timing, and extent of substantive tests. Known or expected adjustments in account balances do not

preclude the auditor from performing analytical procedures during planning, and such procedures should be used to assist the auditor in directing attention to potential material misstatements. The auditor should incorporate his or her knowledge of known adjustments in forming more precise expectations.

2.36 Question 17: How does the interrelation among accounts affect the design of substantive analytical procedures performed on the individual accounts? For example, does a finding that commission expense is 6 percent of sales, as expected, provide evidence of the completeness of both sales and commissions (assume 6 percent is the stated commission rate)?

2.37 Answer: Auditors should carefully consider the relationships and dependencies of the amounts and accounts when designing a substantive analytical procedure to avoid circular reasoning. In the example noted in the question, testing commission expense by comparing the recorded amount with 6 percent of sales may provide evidence regarding completeness of commission expense, provided the auditor has obtained sufficient appropriate audit evidence regarding sales revenue. Because commission expense is dependent on sales, commission expense should not be used to provide evidence on the existence of sales.

2.38 Question 18: Under what circumstances would it be appropriate for an auditor to propose an adjustment based on the results of analytical procedures?

2.39 Answer: In a given situation, an auditor may be able to propose an adjustment for a certain type of account balance. The auditor should consider the level of desired assurance and whether any other substantive tests may assist the auditor in determining a material misstatement. For example, the auditor may consider proposing an adjustment for an unexpected difference found when performing analytical procedures on an estimate, such as a loan loss reserve, when the precision of the analytic is at a sufficient level for the auditor to be able to conclude the reserve is misstated.

Fraud

2.40 Question 19: How effective are analytical procedures for detecting management fraud?

2.41 Answer: Analytical procedures alone would not likely be sufficient for the auditor to determine the presence or absence of fraud. However, analytical procedures may be an effective means for directing the auditor's attention to the possible existence of management fraud. For example, analytical procedures may reveal trends or other changes in account balances or ratios that appear to be inconsistent with the auditor's understanding, obtained to date, of the entity and the environment in which it operates. There are many causes of such inconsistencies. In some cases, there may be initial indications from analytical procedures, in combination with other inquiries and other procedures, that unexpected variances in the account or ratio might possibly be due to fraud.

2.42 Paragraphs .22 and .34 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), discuss the use of analytical procedures in the risk assessment process to help identify risks of material misstatement due to fraud.

.22 Based on analytical procedures performed as part of risk assessment procedures, the auditor should evaluate whether unusual or unexpected relationships that have been identified indicate risks of material misstatement due to fraud. To the extent not already included, the analytical procedures, and evaluation thereof, should include procedures relating to revenue accounts.

.34 The auditor should evaluate, at or near the end of the audit, whether the accumulated results of auditing procedures (including analytical procedures that were performed as substantive tests or when forming an overall conclusion) affect the assessment of the risks of material misstatement due to fraud made earlier in the audit or indicate a previously unrecognized risk of material misstatement due to fraud. If not already performed when forming an overall conclusion, the analytical procedures relating to revenue, required by paragraph .22, should be performed through the end of the reporting period.

Considerations for Audits Performed in Accordance With PCAOB Standards

Paragraph .01 of AS 2401, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*), states that when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs .14–.15 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*), regarding fraud considerations, in addition to the fraud considerations set forth in AS 2401.

Appendix A

Case Study: On the Go Stores

A.01 This appendix provides a case study for On the Go Stores. The case study illustrates the four types of expectation methods discussed in chapter 1, "The Use of Analytical Procedures," of this guide: trend analysis, ratio analysis, reasonableness testing, and regression analysis.

A.02 This case illustrates the use of analytical procedures in both planning and substantive testing for current year sales for a chain of convenience stores named On the Go Stores. The case illustrates the use and effectiveness of the different types of analytical procedures and the factors affecting the precision of each. For example, there are illustrations for trend analysis, ratio analysis, reasonableness testing, and regression analysis in which the analytical procedures are based on financial and nonfinancial data.

Background Information

A.03 On the Go Stores has 23 convenience stores located in the Southeast. Included in the 23 stores are 5 new stores (Nos. 1, 4, 10, 13, and 22) that opened during the year. Operations vary by geographic location and the mix of products sold.

A.04 The location of a store is based on several factors, such as competition and the economic environment of the location. Store Nos. 2, 4, 6, 8, 9, 11, 13, 15, 17, 18, 20, 21, and 23 are considered to be in favorable locations.

A.05 Typically, a store's operations do not change much unless a new product line is introduced, such as selling gas, offering check-cashing services, or selling lottery tickets. The mix of products and services can vary, and the most important factor is whether the store sells gasoline. (Store Nos. 5, 6, 7, 8, 14, 15, 16, 17, 18, 19, 20, and 21 sell gasoline.) These additional product lines typically affect the volume of customers as well as the number of full-time employees.

A.06 On the Go Stores provides the information shown in exhibit A-1.

Exhibit A-1

Relevant Information for On the Go Stores

<i>Store</i>	<i>Prior-Year Sales (Audited) (\$)</i>	<i>Current- Year Sales (\$)</i>	<i>Dollar Change (\$)</i>	<i>Current- Percent Change (%)</i>	<i>Current- Year Inventory (\$)</i>	<i>Square Feet</i>	<i>Average Number Full-Time Employees</i>
1*	N/A	781,793	781,793	N/A	48,725	2,500	11.00
2	1,165,221	1,146,438	(18,783)	(1.16)	44,171	2,500	11.31
3	1,147,430	1,195,004	47,574	4.15	45,714	2,500	12.46
4*	N/A	951,784	951,784	N/A	37,218	4,000	11.86
5	2,037,463	1,981,409	(56,054)	(2.75)	45,826	4,000	10.06
6	2,257,920	2,300,671	42,751	1.89	53,862	4,000	11.10
7	1,850,354	1,956,481	106,127	5.74	49,883	4,000	10.71
8	1,916,884	1,799,713	(117,171)	(6.11)	47,016	4,000	7.50
9	1,833,209	1,820,641	(12,568)	(.69)	59,726	4,000	14.00
10*	N/A	774,954	774,954	N/A	35,882	2,500	11.20
11	980,484	1,159,004	178,520	18.21	37,664	2,500	11.60
12	1,069,652	1,139,475	69,823	6.53	34,662	2,500	12.70
13*	N/A	948,522	948,522	N/A	44,782	4,000	11.86
14	1,795,123	1,984,777	189,654	10.56	38,774	4,000	12.20
15	2,119,015	2,293,847	174,832	8.25	55,423	4,000	11.10
16	1,947,303	1,984,722	37,419	1.92	52,884	4,000	10.40
17	1,705,789	1,798,336	92,547	5.43	46,834	4,000	8.84
18	2,396,971	2,484,503	87,532	3.65	53,772	4,000	12.10
19	1,901,631	1,837,400	(64,231)	(3.38)	43,982	4,000	9.70
20	1,514,798	1,609,385	94,587	6.24	44,893	4,000	7.20
21	1,886,587	1,874,229	(12,358)	(.66)	37,665	4,000	10.50
22*	N/A	698,333	698,333	N/A	33,826	2,500	10.50
23	1,092,908	1,198,229	105,321	9.64	44,857	2,500	10.90
Total	30,618,742	35,719,650	5,100,908	16.66	1,038,041	80,000	250.80

* Store opened during current year.

A.07 As discussed in chapter 1, the use of analytical procedures is a process that has four phases, the first being the formation of an expectation. Some of the factors that affect the precision of the expectation are the nature of the account, the assertion, and the environment. The auditor can assume that these factors are constant throughout the examples presented in the case study when forming an expectation.

Nature of the Account or Assertion

A.08 The following example discusses the factors that an auditor might use to predict sales.

Account: Sales

Assertion: Occurrence or existence of revenue

Audit objective: Overstatement of revenue

Predictability of the relationship: Some examples of factors that the auditor might use to predict sales (predictors) include the following:

- Stable environmental factors (that is, no major changes in employment opportunities or construction activities in the area)
- Prior-year sales
- Product mix (that is, lottery and check cashing)
- Store square feet
- Location (favorable or not favorable)
- Average monthly utility cost per store
- Total labor hours per store
- Inventory turnover rate
- Stores open 24 hours
- Number of employees per store
- The account not affected by management's discretion
- Income statement account

A.09 Factors to be identified and considered that could affect the amount being audited include the following:

- No significant events or accounting changes, except for the opening of the new stores
- Industry and economic factors along with management incentives remaining the same
- Repeat audit engagement
- Materiality \$150,000 or 8 percent change from prior year

A.10 All predictors are not considered in any one example; however, as the precision of the expectation increases, more predictors are used. Example 1 (trend analysis) uses only one predictor, prior-year sales, and more predictors are introduced in examples 2–4 (ratio analysis, reasonableness testing, and regression analysis).

Example 1: Trend Analysis

A.11 Trend analysis can be used in the planning phase of an audit or as a substantive test. Trend analysis typically is more appropriate for the planning

phase of an audit, because it does not take into consideration changes in specific factors that affect the account. However, considering factors that increase the precision of trend analysis may provide the auditor with an appropriate level of assurance for substantive testing.

Expectation Formation (Phase I)

A.12 Following are the relevant factors that affect the precision of the expectation.

Nature of the Account or Assertion

A.13 This information is provided in the "Background Information" section.

Characteristics of the Data

A.14 Level of detail is as follows:

- Sales data are available for the current and prior year, aggregated by stores open all year and those open part of the year, and disaggregated by store.
- For the planning phase of an audit, aggregated data may be appropriate.
- For substantive testing, disaggregated data by category of store (open all year versus part of the year) may be appropriate when there is a stable environment and reasonable controls are in place.

A.15 Reliability of data is as follows:

- The management of On the Go Stores has provided the current-year sales information.
- Current year sales are unaudited; prior-year sales are audited.

Inherent Precision of the Type of Expectation

A.16 With simple trend analysis, the auditor has the expectation that there will be no change from prior-year sales in the current year (predictor is prior-year sales; when prior-year numbers are used as the predictor, the auditor should consider the precision of the expectation and the potential that he or she is ignoring other changes that may have an effect).

Trend Analysis: Planning Phase of the Audit and Substantive Testing

A.17 When using trend analysis for the planning phase, the use of data aggregated at a high level may be appropriate because a high level of assurance is not expected from the procedure.

	<u>Current Year</u>	<u>Prior Year</u>	<u>Change</u>	<u>% Change</u>
<i>Total sales</i>	\$35,719,650	\$30,618,742	\$5,100,908	16.66%

A.18 Because a higher level of assurance is desired when using analytical procedures as substantive tests, an expectation with greater precision should be formed. This can be done by using disaggregated data, such as sales by store, product mix, and location.

A.19 Sales for the new stores opened during the year equal \$4,155,386 (no new stores were opened in the prior year). If that amount were eliminated from the total of current-year sales, the adjusted amount of current-year sales would be \$31,564,264, which could be compared to the prior-year amount resulting in a change of \$945,522, or 3.09 percent.

Planning Phase: Identification, Investigation, and Evaluation (Phases II–IV)

Identification

A.20 Identification begins with the auditor comparing the expected amount with the recorded amount. Unexpected differences, if any, are compared to the established amount of difference from the expectation that the auditor can accept without further explanation. Because the difference for On the Go Stores in the planning phase is in excess of the threshold of \$150,000, or an 8 percent change from prior year, the auditor should design procedures to evaluate the causes of such differences. The auditor could better investigate the difference by disaggregating the data by stores open all year versus stores open part of the year. The auditor should consider whether the 3.09 percent difference is acceptable for the stores open all year.

A.21 Planning is not a discrete phase of the audit, but rather an iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion. As a result of performing planned audit procedures, the auditor may obtain disconfirming evidence that might cause the auditor to revise the overall audit strategy. In accordance with AU-C sections 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and 520, *Analytical Procedures (AICPA, Professional Standards)*, the purpose of using analytical procedures in the planning phase of the audit is to obtain an understanding of the entity and its environment to assess the risks of material misstatement, and to design the nature, timing, and extent of auditing procedures. In evaluating the stores open all year, the auditor evaluates whether the results suggest an increased risk in the sales account. If so, the auditor should consider altering the nature, timing, and extent for the substantive tests planned for the audit.

A.22 Trend analysis as a substantive test will be performed on stores that have been open all of the year. The expectation of current year sales by store is the prior-year sales by store.

Substantive Testing: Identification, Investigation, and Evaluation (Phases II–IV)

Identification

A.23 Identification begins by comparing the expected amount with the recorded amount. In this case the analytical procedure is the percentage change from the prior-year to current-year sales as shown in column 5 of exhibit A-1. The differences are compared with the amount of difference from the expectation that the auditor can accept without further explanation to determine if they are unexpected. In this case, the auditor uses a threshold of an 8 percent change when determining if differences identified should be investigated.

Therefore, the procedure identifies Store Nos. 11, 14, 15, and 23 for further investigation.

Investigation

A.24 As stated in chapter 1, unexpected differences can be due to misstatements or to factors not considered in the development of the expectation. If the auditor believes the unexpected difference could be caused by factors not considered in the development of the expectation (for example, differences in stores that sell gas or lottery tickets), the auditor might consider whether developing a more precise expectation can be cost-effective, such as disaggregated information by product line within a store or adjusting the analysis for general inflation. Otherwise the auditor should consider what additional substantive procedures should be performed. Paragraph .07 of AU-C section 520 states that inquiry of management may assist the auditor in determining the causes of the unexpected differences. However, management responses should be corroborated with other audit evidence. For example, if management explains the increase in current-year sales as a result of a new product line that was introduced only in the current year, the auditor could perform a sales analysis to determine that the items were sold only in the current year and did not appear in the prior-year sales analysis.

Evaluation

A.25 The results from a second, more precise trend analysis or additional substantive testing to verify the explanations provided by management may provide the auditor with a basis of concluding whether a material misstatement exists. Paragraph .07 of AU-C section 450, *Evaluation of Misstatements Identified During the Audit* (AICPA, *Professional Standards*), states that the auditor should communicate on a timely basis and request management to record the adjustment needed to correct all known misstatements, including the effect of prior period misstatements (see paragraph .11 of AU-C section 450), other than those that the auditor believes are trivial.

Example 2: Ratio Analysis

A.26 A ratio analysis involves the comparison of relationships between financial statement accounts, a comparison of an account with nonfinancial data, or a comparison of relationships across an industry, such as gross profit comparisons. See appendix C, "Financial Ratios," of this guide for additional helpful ratios.

Expectation Formation (Phase I)

A.27 These are the relevant factors that affect the precision of the expectation.

Nature of the Account or Assertion

A.28 The "Background Information" section contains this information.

Characteristics of the Data

A.29 Level of detail is as follows:

- The auditor has available sales data and cost of goods sold data for stores open all year that sell gas and that do not sell gas.

A.30 Reliability of data is as follows:

- The management of On the Go Stores has provided the auditor with total sales and cost of goods sold data for stores open all year by those that sell gas and those that do not sell gas.
- Sales and cost of goods sold information are unaudited; however, the gross margin percentage can be calculated by the auditor to ensure mathematical accuracy.

Inherent Precision of the Type of Expectation

A.31 *Ratio analysis.* The predictor is the gross profit percentage for stores that sell gas compared with stores that do not sell gas. A higher gross profit percentage is expected for stores that sell gas due to higher volume.

	<u>Current Year</u>	<u>Prior Year</u>
All stores open all year (excludes new stores):		
Total sales	\$31,564,264	\$30,618,742
Cost of goods sold	21,463,700	21,987,932
Gross margin	\$10,100,564	\$8,630,810
Gross margin percentage	31.99%	28.19%
Stores that sell gas:		
Total sales	\$23,905,473	\$23,329,838
Cost of goods sold	16,112,291	16,307,557
Gross margin	\$7,793,182	\$7,022,281
Gross margin percentage	32.6%	30.1%
Stores that do not sell gas:		
Total sales	\$7,658,791	\$7,288,904
Cost of goods sold	5,351,409	5,680,375
Gross margin	\$2,307,382	\$1,608,529
Gross margin percentage	30.1%	22.1%

Identification, Investigation, and Evaluation (Phases II–IV)

Identification

A.32 Identification begins by comparing the expected amount with the recorded amount. In this case the analytical procedure is the comparison of the gross profit percentage for the current to prior year for stores that sell gas and stores that do not sell gas. The differences are compared with the amount of difference from the expectation that the auditor can accept without further explanation to determine if they are unexpected. For example, assume that an acceptable difference for a certain On the Go Store is 10 percent. The percentage threshold will not necessarily be the same for trend and ratio analysis. The auditor should use professional judgment to determine the threshold based on materiality, risk, and the objective of the procedure. Using the aggregate

analysis for all stores open all year, the procedure identifies an unexpected difference of 13.5 percent in gross margin percentage (31.99 percent – 28.19 percent / 28.19 percent). However, a more precise expectation can better identify the source of the unexpected difference. Specifically, for the stores that sell gas, the difference in gross margin percentage is only 8.3 percent (32.6 percent – 30.1 percent / 30.1 percent) which is below the threshold. In contrast, the difference in gross margin percentage for those stores that do not sell gas is 36.5 percent (30.1 percent – 22.1 percent / 22.1 percent). This suggests that the 6 stores that do not sell gas should be investigated further.

Investigation

A.33 If the auditor believes the unexpected difference could be caused by other factors not considered in the development of the expectation (for example, location or degree of competition), the auditor might consider whether developing a more precise expectation can be cost-effective. Otherwise the auditor should consider what additional substantive procedures should be performed. Paragraph .07 of AU-C section 520 states that inquiry of management may assist the auditor in determining the causes of the unexpected differences. However, management responses should be corroborated with other audit evidence.

Evaluation

A.34 The results from a second, more precise reasonableness test or additional substantive testing on the stores that do not sell gas may provide the auditor with a basis of concluding whether a material misstatement exists. Paragraph .07 of AU-C section 450 states that the auditor should communicate on a timely basis and request management to record the adjustment needed to correct all known misstatements, including the effect of prior period misstatements (see paragraph .11 of AU-C section 450), other than those that the auditor believes are trivial.

A.35 This example shows how the use of financial ratios, along with disaggregated information, can increase the precision of the expectation.

Example 3: Reasonableness Test

A.36 A reasonableness test is an analysis of an account balance that involves developing an expectation based on financial data, nonfinancial data, or both.

Expectation Formation (Phase I)

A.37 Following are the relevant factors that affect the precision of the expectation.

Nature of the Account or Assertion

A.38 This information is provided in the "Background Information" section.

Characteristics of the Data

A.39 Level of detail is as follows:

- The auditor has available sales data and square footage data by store.

A.40 Reliability of data is as follows:

- The management of On the Go Stores has provided the auditor with the amount of square footage per store and sales per stores (see exhibit A-1). The region's average sales per square footage can be obtained from information provided by the National Association of Convenience Stores (NACS), which publishes information on the convenience store industry.
- Sales information is unaudited; however, square footage data can be independently verified by the auditor to increase its reliability.

Inherent Precision of the Type of Expectation

A.41 *Reasonableness test.* The predictor is sales per square foot by store.

A.42 In performing a reasonableness test of On the Go Stores' current-year sales using the information provided, the auditor calculates the average sales amount per square foot and compares it with the region's average sales per square foot. If only a low level of assurance is desired from the procedure, conducting the test using aggregated data is appropriate. However, a higher level of assurance may be obtained through the formation of a more precise expectation, for example, by disaggregation by store as shown in exhibit A-2.

Exhibit A-2

Reasonableness Test Based on Sales per Square Foot

<i>Store</i>	<i>Current Year Sales (\$)</i>	<i>Square Feet</i>	<i>Sales per Square Foot (\$)</i>	<i>Average per Square Foot per NACS (\$)</i>	<i>Difference (\$)</i>	<i>Difference (%)</i>
1*	781,793	2,500	313	490	177	36.20
2	1,146,438	2,500	459	490	31	6.40
3	1,195,004	2,500	478	490	12	2.40
4*	951,784	4,000	238	490	252	51.40
5	1,981,409	4,000	495	490	(5)	(1.10)
6	2,300,671	4,000	575	490	(85)	(17.40)
7	1,956,481	4,000	489	490	1	.02
8	1,799,713	4,000	450	490	40	8.20
9	1,820,641	4,000	455	490	35	7.10
10*	774,954	2,500	310	490	180	36.70
11	1,159,004	2,500	464	490	26	5.40
12	1,139,475	2,500	456	490	34	7.00
13*	948,522	4,000	237	490	253	51.60
14	1,984,777	4,000	496	490	(6)	(1.30)

(continued)

Analytical Procedures

<i>Store</i>	<i>Current Year Sales (\$)</i>	<i>Square Feet</i>	<i>Sales per Square Foot (\$)</i>	<i>Average per Square Foot per NACS (\$)</i>	<i>Difference (\$)</i>	<i>Difference (%)</i>
15	2,293,847	4,000	573	490	(83)	(17.00)
16	1,984,722	4,000	496	490	(6)	(1.30)
17	1,798,336	4,000	450	490	40	8.20
18	2,484,503	4,000	621	490	(131)	(26.80)
19	1,837,400	4,000	459	490	31	6.30
20	1,609,385	4,000	402	490	88	17.90
21	1,874,229	4,000	469	490	21	4.40
22*	698,333	2,500	279	490	211	43.00
23	1,198,229	2,500	479	490	11	2.20
Total	35,719,650	80,000	446	490	—	—

* Store opened during current year.

A.43 After reviewing the information provided by NACS, the auditor determines that the information reflects only stores that have been in operation for a full year; therefore, it would be appropriate to isolate the stores that have been open for less than a full year, as in the following table:

Reasonableness Testing—Total for Stores Open All Year

	<i>Sales</i>	<i>Total Square Footage</i>
Total sales and square footage for the year	\$35,719,650	80,000
Less: sales and square footage for stores opened part of the year (Store Nos. 1, 4, 10, 13, 22)	4,155,386	15,500
Sales and square footage for stores opened for full year	<u>\$31,564,264</u>	64,500
Average sales per square foot (provided by NACS)		× \$490
Expected total sales for stores open for a full year		\$31,605,000
Actual On the Go sales for the current year (stores open for a full year)		31,564,264
Difference		\$40,736 or 0.13%

A.44 To perform reasonableness testing by store, the auditor calculates the sales per square foot for each store and ranks the results (see exhibit A-2). The results for the 5 new stores are relatively small and can be disregarded

for this analysis. The remaining stores can be compared to the \$490 national average square foot, provided by NACS.

Identification, Investigation, and Evaluation (Phases II–IV)

Identification

A.45 The auditor begins identification by comparing the expected amount with the recorded amount. In this case the analytical procedure is the difference from the NACS average sales per square foot to recorded current year sales per square foot, as calculated in exhibit A-2. The differences are compared with the amount of difference from the expectation that the auditor can accept without further explanation to determine if they are unexpected. For example, the threshold is 15 percent, and any changes greater than the threshold are considered an unexpected difference and investigated. According to the aggregate analysis for the stores open all year, the results do not identify an unusual fluctuation based on the materiality threshold. However, the analysis by store for the stores open all year identifies Store Nos. 6, 15, 18, and 20 for further investigation.

Investigation

A.46 If the auditor accepts the difference of 0.13 percent calculated in the first reasonableness test, the sales account balance is accepted without further investigation. However, the second reasonableness test, which is more precise because it is based on disaggregated data, does indicate the need for further investigation. If the auditor believes the unexpected difference could be caused by factors not considered in the development of the expectation (for example, differences in stores that sell gas or operate in more favorable locations), the auditor might consider whether developing a more precise expectation can be cost-effective. Otherwise the auditor should consider what additional substantive procedures should be performed. Paragraph .07 of AU-C section 520 states that inquiry of management may assist the auditor in determining the causes of the unexpected differences. However, management responses should be corroborated with other audit evidence.

Evaluation

A.47 If the auditor accepts the results of the first reasonableness test as sufficient appropriate evidence for the existence of sales, no evaluation is performed. However, this test is relatively imprecise and is applicable only if the auditor desires a low level of assurance. The results of the second, more precise reasonableness test followed by additional investigation may provide the auditor with a basis of concluding whether a material misstatement exists. Paragraph .07 of AU-C section 450 states that the auditor should communicate on a timely basis and request management to record the adjustment needed to correct all known misstatements, including the effect of prior period misstatements (see paragraph .11 of AU-C section 450), other than those that the auditor believes are trivial.

A.48 This example illustrates how the use of financial and independent nonfinancial information can give the auditor a greater precision in forming the expectation and in return provide a greater level of assurance.

Example 4: Regression Analysis

A.49 Regression analysis has the same objective as trend, ratio analysis, and reasonableness testing, that is, to identify the potential for misstatement. The advantage of regression analysis over the other methods is that the regression: (a) provides an explicit, mathematically objective, and precise method for forming an expectation; (b) allows the inclusion of a larger number of relevant independent variables; and (c) provides direct and quantitative measures of the precision of the expectation.

A.50 The auditor's specific objective in using regression for On the Go Stores is to determine which store should be targeted for initial investigation for potential misstatement in sales. The regression analysis determines which stores have total sales that are most out of line in comparison with the others. This type of analysis is called cross-sectional regression (as opposed to longitudinal or time-series regression) because a cross-section of relevant information about each store is used in determining which stores are most unusual. In predicting sales, the cross-sectional data usually include relevant predictors, such as the size of the store (as used in the reasonableness testing preceding), and other features that cause higher sales at the store, such as whether it sells gas, sells lottery tickets, and so on.

A.51 The alternative type of regression is called time-series regression because it uses the data from several (usually 20–40) prior audited (usually monthly) time periods to develop a regression model to predict future periods. A time-series model is used to predict the monthly sales figures for the current audit year based on prior year data in order to assess the reasonableness of the reported monthly sales figures. Both types of regression analysis can be used to provide substantive appropriate evidence. The type of regression used in the following example is cross-sectional.

Cross-Sectional Regression

A.52 The auditor begins a regression application for On the Go Stores by selecting the dependent variable, in this case, the amount of sales (includes merchandise sales and gas sales) at each of the 23 stores. The audit objective is to examine sales analytically to determine the potential for overstatement and to address the auditor's objectives for testing occurrence and existence. A preliminary assessment of materiality is set at \$150,000. Second, the auditor selects the relevant independent variables, that is, those factors that the auditor knows from experience with the client and industry will be useful predictors of sales at each store.

Independent Variables

A.53 The independent variables are as follows (see exhibit A-3 for data):

- The level of inventory (merchandise plus gas) at the store.
- The number of staff at the store (full-time equivalent employees, or FTEs).
- Whether the store opened or closed during the year, or for any reason was not open the entire year. This variable is entered as a binary, or "0/1" variable: a 0 if the store was open all year, and a 1 if the store was open only part of the year.

- Distinctive characteristics of each store, such as whether it sells gas. This variable is also entered as a binary variable: a value of 1 if it sells gas, and a value of 0 if it does not sell gas.
- Square feet of floor space at each store. In this case, there are only 2 size stores (1 at 2,500 square feet and 1 at 4,000 square feet). Thus, for simplicity and clarity this variable is entered into the regression as a binary variable, which has a value of 0 for stores with 2,500 square feet, and a value of 1 for stores of 4,000 square feet.

A.54 Depending on the auditor's local knowledge, additional variables might be included, for example, whether the store has a check-cashing facility, whether it is an attractive location (for example, near to an intersection of highways, a ballpark, or other "draw" of customers), the number of parking places, and other factors about the general competitive environment for the store.

Exhibit A-3

Regression Variables for On the Go Stores

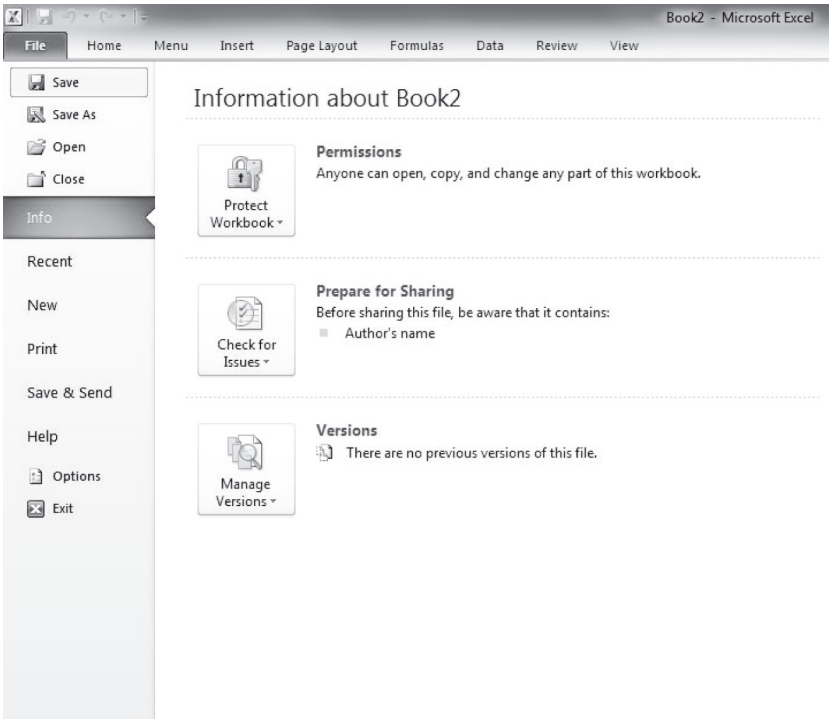
<i>Store</i>	<i>Merchandise Inventory (\$)</i>	<i>Full-Time Employees</i>	<i>New Store</i>	<i>Sells Gas</i>	<i>Size</i>	<i>Sales (\$)</i>
1	48,725	11.00	1	0	0	781,793
2	44,171	11.31	0	0	0	1,146,438
3	45,714	12.46	0	0	0	1,195,004
4	37,218	11.86	1	0	1	951,784
5	45,826	10.06	0	1	1	1,981,409
6	53,862	11.10	0	1	1	2,300,671
7	49,883	10.71	0	1	1	1,956,481
8	47,016	7.50	0	1	1	1,799,713
9	59,726	14.00	0	0	1	1,820,641
10	35,882	11.20	1	0	0	774,954
11	37,664	11.60	0	0	0	1,159,004
12	34,662	12.70	0	0	0	1,139,475
13	44,782	11.86	1	0	1	948,522
14	38,774	12.20	0	1	1	1,984,777
15	55,423	11.10	0	1	1	2,293,847
16	52,884	10.40	0	1	1	1,984,722
17	46,834	8.84	0	1	1	1,798,336
18	53,772	12.10	0	1	1	2,484,503
19	43,982	9.70	0	1	1	1,837,400
20	44,893	7.20	0	1	1	1,609,385
21	37,665	10.50	0	1	1	1,874,229
22	33,826	10.50	1	0	0	698,333
23	44,857	10.90	0	0	0	1,198,229

A.55 The auditor enters the data into an Excel spreadsheet (other spreadsheet programs and statistical systems can also be used) and performs a regression analysis on the data. In Excel, this is accomplished through the following five steps:

1. From the File Tab, choose Options (see exhibit A-4).

Exhibit A-4

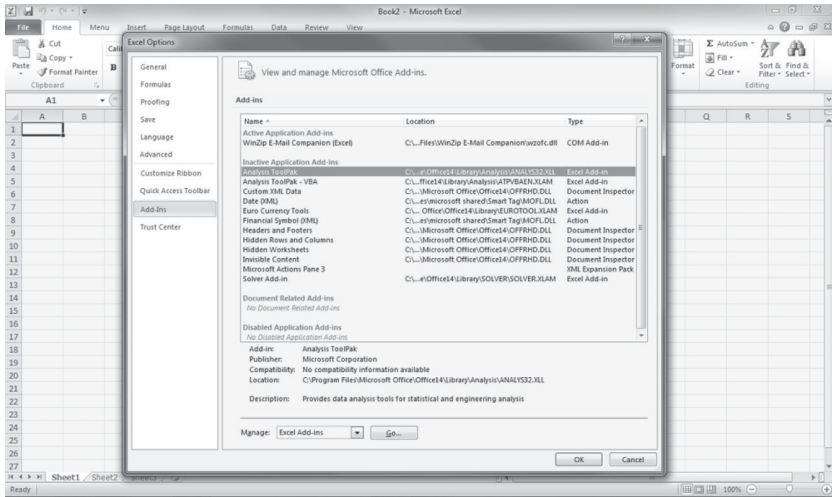
Selecting Excel Options



- From the Options menu, select Add-Ins, then use the drop-down box at the bottom of the page to Manage: Excel Add-ins, and select Go (see exhibit A-5).

Exhibit A-5

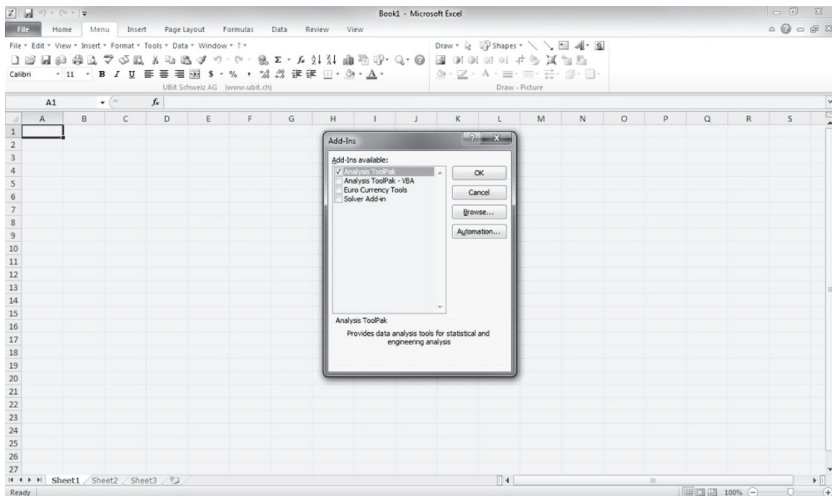
Selecting Excel Add-Ins



- From the Excel Add-Ins Page, select Analysis ToolPak, and select OK (see exhibit A-6).

Exhibit A-6

Selecting Analysis Tool Pak to Install Regression

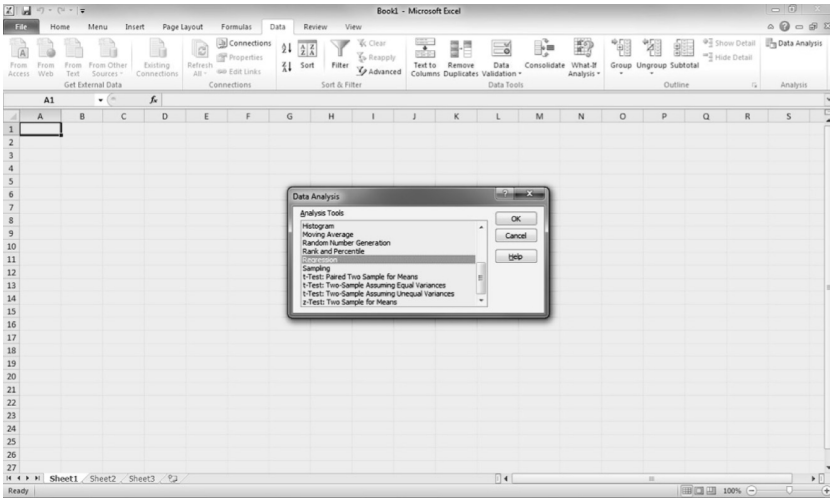


A.56 The effect of these first three steps is to install regression (and other statistical procedures) so they are available in Excel. (Please note that the version of Excel used in the case study is Office 2010. Upgraded versions may be available.)

4. Select the Data Tab, and select Data Analysis and choose Regression from the Data Analysis box, then select OK (see exhibit A-7).

Exhibit A-7

Selecting Regression in Excel



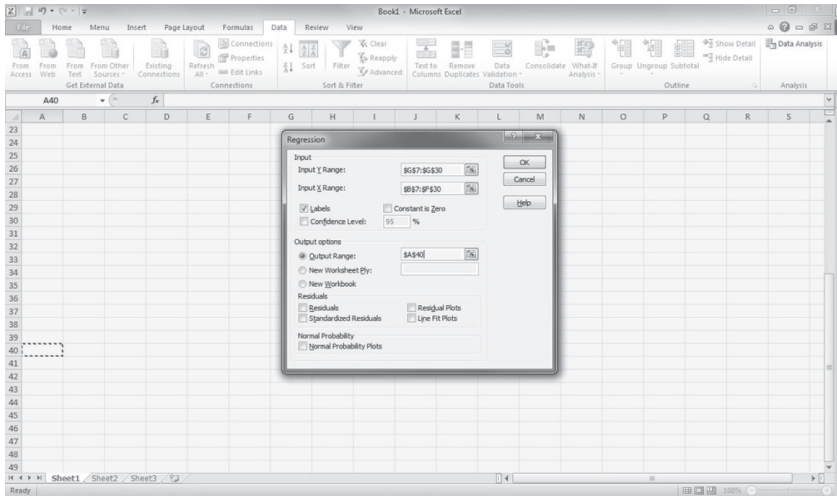
5. Complete 3 items in the Regression box (see exhibit A-8).

Exhibit A-8

Entering the Necessary Information Into the Excel Regression Procedure

- a. Enter the spreadsheet ranges of the dependent and independent variables (the variables are entered in columns, a row for each store. In this case, G7:G30 and B7:F30 are the ranges for the dependent and independent variables respectively; also, include in these ranges a row at the top which gives the name of the variable in each column so the regression output will label the variables properly).
- b. Select Labels.
- c. Select the location for the output among the report options (in this case, the cell A40).

- d. To calculate the residual amounts for each item, select the Residual's box in exhibit A-8.



A.57 The regression results for On the Go Stores are shown in exhibits A-9 and A-10.

Exhibit A-9

Regression Results for All Variables

SUMMARY OUTPUT

Regression Statistics

(Note: The important information in the Summary Output Table is the R squared value, .975, and the standard error, \$97,961.)

SUMMARY OUTPUT

Regression Statistics

Multiple R	0.987
R Squared	0.975
Adjusted R Squared	0.967
Standard Error	97,961
Observations	23

ANOVA

	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	5	6.314E+12	1.263E+12	1.316E+02	5.680E-13
Residual	17	1.631E+11			
Total	22	6.478E+12			

Analytical Procedures

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-Value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>
Intercept	(746,293)	244,813	(3.048)	0.007	(1,262,804)	(229,783)
Inventory	16.1179	4	4.504	0.000	9	24
FTE	106,114	17,725	5.987	0.000	68,717	143,511
New Store	(303,431)	67,863	(4.471)	0.000	(446,609)	(160,253)
Sells Gas	804,866	94,751	8.495	0.000	604,959	1,004,773
Size-Loc	93,247	77,838	1.198	0.247	(70,977)	257,470

RESIDUAL OUTPUT (Note: A negative number means potential understatement; a positive number means potential overstatement.)

<i>Observation</i>	<i>Predicted Sales</i>	<i>Residuals</i>
1	902,875	(121,082)
2	1,165,801	(19,363)
3	1,312,702	(117,698)
4	901,911	49,873
5	1,957,946	23,463
6	2,197,829	102,842
7	2,092,311	(135,830)
8	1,705,475	94,238
9	1,795,209	25,432
10	717,095	57,859
11	1,091,694	67,310
12	1,160,034	(20,559)
13	1,023,827	(75,305)
14	2,071,367	(86,590)
15	2,222,989	70,858
16	2,107,786	(123,064)
17	1,844,734	(46,398)
18	2,302,492	182,011
19	1,890,024	(52,624)
20	1,639,423	(30,038)
21	1,873,098	1,131
22	609,677	88,656
23	1,133,351	64,878

Exhibit A-10**Regression Results for On the Go Stores With the Size Variable Removed**SUMMARY OUTPUT
Regression Statistics

Multiple R	0.986
R Squared	0.973
Adjusted R Squared	0.967
Standard Error	99,138
Observations	23

ANOVA

	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	4	6.30072E+12	1.575E+12	160.26934	8.2455E-14
Residual	18	1.7691E+11	9.828E+09		
Total	22	6.47763E+12			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-Value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>
Intercept	(865,347)	226,422	-3.822	0.001	(1,341,043)	(389,651)
Inventory	17.5503	3	5.141	0.000	10	25
FTE	111,944	17,249	6.490	0.000	75,705	148,183
New Store	(270,284)	62,710	-4.310	0.000	(402,034)	(138,535)
Sells Gas	890,046	63,378	14.043	0.000	756,894	1,023,198

RESIDUAL OUTPUT (*Note: A negative number means potential understatement; a positive number means potential overstatement.*)

<i>Observation</i>	<i>Predicted Sales</i>	<i>Residuals</i>
1	950,891	(169,098)
2	1,175,955	(29,517)
3	1,331,770	(136,766)
4	845,212	106,572
5	1,955,116	26,293
6	2,212,572	88,099
7	2,099,081	(142,600)
8	1,689,424	110,289
9	1,750,079	70,562
10	747,882	27,072
11	1,094,219	64,785

(continued)

Analytical Procedures

<u>Observation</u>	<u>Predicted Sales</u>	<u>Residuals</u>
12	1,164,671	(25,196)
13	977,963	(29,441)
14	2,070,912	(86,135)
15	2,239,968	53,879
16	2,117,047	(132,325)
17	1,836,235	(37,899)
18	2,322,937	161,566
19	1,882,454	(45,054)
20	1,618,582	(9,197)
21	1,861,144	13,085
22	633,438	64,895
23	1,142,097	56,132

A.58 The assessment of the precision of the regression involves a consideration of the R squared, t statistic, and standard error of the estimate, which are contained in the "Summary Output" section of the spreadsheet report. The proper interpretation of these three values is explained in appendix B, "Measures of Precision for a Regression Analysis," of this guide.

Expectation Formation (Phase I)

A.59 When using regression, expectation formation is accomplished by the regression analysis, using the independent variables entered by the auditor, as shown in the "Coefficients" column of exhibit A-9. For On the Go Stores, the expectation model is the following regression model:

$$\begin{aligned}
 \text{Sales} = & - \$746,293 + 16.1179 \times \text{inventory} \\
 & + \$106,114 \times \text{full-time employees} \\
 & - \$303,431 \times \text{new store} \\
 & + \$804,866 \times \text{sells gas} \\
 & + \$93,247 \times \text{size}
 \end{aligned}$$

A.60 For example, the expectation for sales in Store No. 2 is derived by using the equation in the following way (data from exhibit A-3):

$$\begin{aligned}
 \text{Sales} = & - \$746,293 + 16.1179 \times \$44,171 \\
 & + \$106,114 \times 11.31 \\
 & - \$303,431 \times 0 \\
 & + \$804,866 \times 0 \\
 & + \$93,247 \times 0 \\
 = & \$1,165,800
 \end{aligned}$$

A.61 The regression prediction for sales can be compared to the actual value of sales for Store No. 2, \$1,146,438. The difference, \$19,362 (\$1,165,800

– \$1,146,438), is a measure of the degree to which Store No. 2 differs from the other stores, based on a regression model derived from all 23 stores. The predicted sales calculation in paragraph A.60 differs slightly from the predicted sales calculation in exhibit A-9 as a result of rounding.

Evaluating the Precision of the Regression Using R Squared, the t Statistic, and the Standard Error

A.62 The assessment of the precision of the regression is done by considering three statistical measures that are provided in the regression output.

A.63 In exhibit A-9, R squared is excellent (at 97.5 percent), the standard error is reasonable (\$97,961 is less than 5 percent of the average value of the dependent variable), and the t statistics are all greater than 2.0, except for Size, for which the t statistic is 1.198.

A.64 The standard error of \$97,961 is substantially less than the planned materiality of \$150,000, which provides further confidence in the use of the regression. In contrast, if the standard error is greater than roughly 75 percent of materiality, the auditor should consider limiting reliance on the regression.

A.65 Also the signs of the t statistics are in the expected direction. That is, each of the variables except variable 3 (a new store) is expected to have a positive relationship with the dependent variable: As the independent variable increases, the dependent variable is expected to increase. In contrast, for new stores, lower sales are expected, as indicated by the negative sign on variable 3. Thus, both the amount and direction of the t statistics are consistent with expectations. Overall, the precision of the regression is assessed to be quite good. The regression output contains additional information, but to obtain a concise and effective evaluation of the precision of the regression, the auditor can confine himself or herself at this point to a consideration of the three statistics noted previously.¹

A.66 The auditor's overall evaluation then, is that the regression in exhibit A-9 is useful, because the statistical measures are good. Also, because one of the variables, Size, has an insignificant t statistic, it could be removed from the regression to potentially improve the standard error and the t statistics of the remaining variables. This is done in exhibit A-10. The standard error becomes slightly worse (\$99,138 rather than \$97,961), but the t statistics improve overall. Although judgment is involved, the auditor is likely to prefer the second regression in exhibit A-10 because the relatively poor variable, Size, is removed, and the remaining t statistics are improved.

Identification, Investigation, and Evaluation (Phases II–IV)

A.67 To examine the stores for the completeness and existence of sales, the auditor first identifies stores with large prediction errors (labeled the *residuals* in the regression output), that is, the difference between the actual sales and

¹ To further study the validity of the model, the regression can be run on a portion of the data and compared with the model for the entire data set. This was done using only the first 11 stores, and the results are comparable to that shown in exhibit A-9. The statistical measures are similar to those in exhibit A-9, except that across the board, all the measures are not as good (for example, the t statistics are 1.78, 2.32, -3.84, 4.30, and 2.09 for each of the independent variables respectively, in contrast to t statistics of 4.5, 5.98, -4.47, 8.49, and 1.198 in exhibit A-9). The decline in the statistical measures is due largely to the relatively small number of data points. Generally, the larger the number of data points, the better the statistical measures will be.

predicted sales for each store. A common approach is to identify and focus on the largest few residuals. In particular, the auditor may choose all stores that have residuals greater than the standard error. The total number of stores to pick depends on the number of large residuals. The more stores with large residuals, the more stores should be selected to achieve the desired level of assurance.

A.68 Because the auditor in this case is looking for overstatements, the positive residuals are important; stores with positive residuals are those for which the regression predicts a lower level of sales than the actual number, a potential overstatement. Exhibit A-10 shows that the largest positive residuals are at Store Nos. 4, 8, and 18. The analysis points to beginning further investigation (if any) at stores 4, 8, and 18, because the regression shows them to be the most out of line with the other stores, based on the relationships in the data for these 4 independent variables.

A.69 Once the stores have been identified, the auditor begins a further analytical investigation. The goal of the additional analysis is to explain why these four stores are out of line in comparison with the others. The further analytics can be based on product line analysis or more detailed analysis of the predictor factors (that is, for new stores, how many months they were open). For example, On the Go Stores sales can be divided into the product lines: grocery and other merchandise, beer and wine, lottery, and gasoline. A more detailed analytical study can help explain why a store is out of line. For example, the analytics might show that Store No. 8's sales are unusual because of an unusually large amount of sales of beer and wine. The explanations derived in this manner are then taken to management as a basis for inquiry, to corroborate the explanations found in the analytics or to discover new explanations. For example, management might respond that the unusual sales for Store No. 8 are not likely due to beer and wine sales, but rather to a construction project near the store, which increased traffic at the store and increased sales significantly. Management's explanations should be corroborated by further analytics, inquiry, or testing.

Use of Regression in Review Engagements

A.70 Regression analysis can be used in the same manner for review engagements, to direct attention to accounts or to areas (that is, stores) where there is the greatest potential for misstatement.

Regression and Fraud Detection

A.71 Because of the potential for collusion in cases of fraud, the auditor cannot rely on regression to detect fraud. However, because of its precision, regression can sometimes be a useful resource for directing auditors' attention to potential fraud. To illustrate, assume there are no material errors at On the Go Stores, but there is a material fraud of \$1,000,000 in which the management of On the Go has overstated net income by overstating sales by \$1,000,000. The debit side of the misstatement is spread over selected balance sheet accounts. The credit side of the fraud is \$250,000 spread over sales at each of the 4 stores: Store Nos. 4, 10, 12, and 22. On the Go's management chose these 4 stores because they have the lowest merchandise levels of the 23 stores, and their expectation was that the auditor was unlikely to select the stores with the smallest inventories for detail tests. The auditor has identified certain risk factors that indicate the potential for fraud and is planning to use regression

as one part of the audit plan to satisfy the auditor's responsibility under AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), which is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit.

Considerations for Audits Performed in Accordance With PCAOB Standards

Paragraph .01 of AS 2401, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*), states when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs .14–.15 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*), regarding fraud considerations, in addition to the fraud considerations set forth in AS 2401.

A.72 The results of the regression (excluding the size variable), now including the fraud in the four stores, is shown in exhibit A-11. Note that the R squared, standard error, and t statistics are still quite good, though the effect of the fraud is to reduce the overall precision of the regression slightly.² The analysis of the residuals shows the following. Suppose the auditor were to pick the 4 stores with the largest positive residuals to investigate for fraud. This strategy would pick Store Nos. 4, 8, 18, and 22. Two of the four (Store Nos. 4 and 22) have fraudulent sales, so the regression has correctly identified them as needing investigation. The regression also led to the choice of Store Nos. 8 and 18, for which there is no error or fraud. The unusually large residuals for Store Nos. 8 and 18 are likely due to factors not included in the regression—variables that would have caused these stores to have higher sales predictions if included—or other factors that are difficult to include in the regression such as turnover of management at the store or short-term personnel problems.³

A.73 The regression failed to identify Store Nos. 10 and 12 as needing investigation. Overall then, the score of the regression is two "hits," two "misses," and two "false alarms"—probably a good overall performance given that the fraud is spread over four stores. If the fraud is spread over more than four stores, the regression's model performance would be better. However, it is important to note that trend and ratio analysis or reasonableness testing are less precise and therefore less likely to reveal the fraud. For example, the next section examines how reasonableness testing would have performed in detecting this fraud.

² Although poor statistical measures are most likely due to modeling difficulties (missing independent variables, inaccurate data, and unstable data), it can also be due to fraud. The effect of the fraud is to reduce the explanatory power of the independent variables and therefore to make the statistical measures less favorable.

³ There are two types of management fraud: (a) misstatement of the financial report (usually by top management), and (b) misappropriation of assets (theft, usually by lower level managers and employees). The application of regression illustrated here is the first type; the focus is on the discovery of overstatement. In contrast, if the objective is discovery of theft, the auditor would focus also on understatements and would therefore investigate those stores with large negative residuals. In exhibit A-11, this would be Store Nos. 1, 3, 13, and 14.

Exhibit A-11**Regression Results for the Fraud Data**

SUMMARY OUTPUT

Regression Statistics

Multiple R	0.966830033
R Squared	0.934760313
Adjusted R Squared	0.920262604
Standard Error	139385.2781
Observations	23

ANOVA

	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	4	5.01066E+12	1.233E+12	64.476419	2.01524E-10
Residual	18	3.49709E+11	1.934E+09		
Total	22	5.36037E+12			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-Value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>
Intercept	(652,163)	318,344	-2.049	0.055	(1,320,979)	16,653
Inventory	10.5906	5	2.207	0.041	1	21
FTE	123,287	24,252	5.084	0.000	72,336	174,238
New Store	(182,473)	88,169	-2.070	0.053	(367,709)	2,764
Sells Gas	893,157	89,108	10.023	0.000	705,949	1,080,365

RESIDUAL OUTPUT

<i>Observation</i>	<i>Predicted Sales</i>	<i>Residuals</i>
1	1,037,549	(255,756)
2	1,210,012	(63,574)
3	1,368,133	(173,129)
4	1,021,710	180,074
5	1,966,587	14,822
6	2,179,911	120,760
7	2,089,689	(133,208)
8	1,663,574	136,139
9	1,706,391	114,250
10	926,192	98,762
11	1,176,852	(17,848)

12	1,280,675	108,800
13	1,101,818	(153,296)
14	2,155,736	(170,959)
15	2,196,443	97,404
16	2,083,253	(98,531)
17	1,826,852	(28,516)
18	2,302,245	182,258
19	1,902,674	(65,274)
20	1,604,104	5,281
21	1,934,403	(60,174)
22	818,117	130,216
23	1,166,729	31,500

Reasonableness Testing by Store

A.74 The reasonableness test based on square feet shown in exhibit A-12 can be compared with the reasonableness test in exhibit A-2. Store Nos. 4, 10, and 22 may not be indicated for a fraud involving overstatement of revenues using this analysis because their sales-per-square-foot values (\$300, \$410, and \$379, respectively) are below the national average of \$490 per square foot in the first year of operation, which might be considered reasonable depending upon factors including the date operations began and market conditions in the area of the store.

Exhibit A-12

Reasonableness Test Based on Sales per Square Foot With Fraud in Store Nos. 4, 10, 12, and 22

<i>Store</i>	<i>Square Foot</i>	<i>Sales</i>	<i>Sales / Square Foot</i>
13	4,000	948,522	237 New Store
4	4,000	1,201,784	300 New Store
1	2,500	781,793	313 New Store
22	2,500	948,333	379 New Store
20	4,000	1,609,385	402
10	2,500	1,024,954	410 New Store
14	4,000	1,609,385	402
17	4,000	1,798,336	450
8	4,000	1,799,713	450
9	4,000	1,820,641	455
2	2,500	1,146,438	459

(continued)

Analytical Procedures

<i>Store</i>	<i>Square Foot</i>	<i>Sales</i>	<i>Sales/Square Foot</i>
19	4,000	1,837,400	459
11	2,500	1,159,004	464
21	4,000	1,874,229	469
3	2,500	1,195,004	478
23	2,500	1,198,229	479
7	4,000	1,956,481	489
5	4,000	1,981,409	495
16	4,000	1,984,722	496
14	4,000	1,984,777	496
12	2,500	1,389,475	556
15	4,000	2,293,847	573
6	4,000	2,300,671	575
18	4,000	2,484,503	621
Total	80,000	36,719,650	

A.75 Also, using this analysis in exhibit A-2, Store No. 12 has sales per square foot (\$556) above the national average, but it is unlikely that it would be indicated for fraud using this approach because there are other stores that are further above the national average (Store Nos. 6, 15, and 18). Thus, it appears that the reasonableness testing approach based on individual stores, as illustrated in exhibit A-12, probably would not be as effective as regression analysis at detecting the stores with fraud. This might be explained in part by the lack of significance of the size (square feet) variable in exhibit A-9. Because size did not appear as a significant variable in the regression, square footage may not be a reliable basis for forming an expectation about store sales in this case.

Appendix B

Measures of Precision for a Regression Analysis

B.01 Unlike trend and ratio analysis or reasonableness testing, which provide no direct measures of the precision of their expectations, regression analysis provides direct, quantitative measures of the precision of its expectation. Many computer-based statistical software systems, such as Excel (used in this example), provide these measures as part of the regression results. There are three key measures of precision provided in the regression:

- a. R squared
- b. The t statistic
- c. The standard error of the estimate

B.02 R squared is a number between 0 and 1 and measures the degree to which changes in the dependent variable can be estimated by changes in the independent variable(s). A more precise regression is one that has a relatively high R squared (close to 1). When viewed graphically, models with high R squared show the data points lying near to the regression line, whereas in low R squared models, the data points are somewhat dispersed, as demonstrated in exhibit B-1 and exhibit B-2. Determining an acceptable R squared is a matter of judgment; most regression analyses involving financial data have R squared values above .5, and many have values in the .8 to .9 range.

Exhibit B-1

Regression With High R Squared

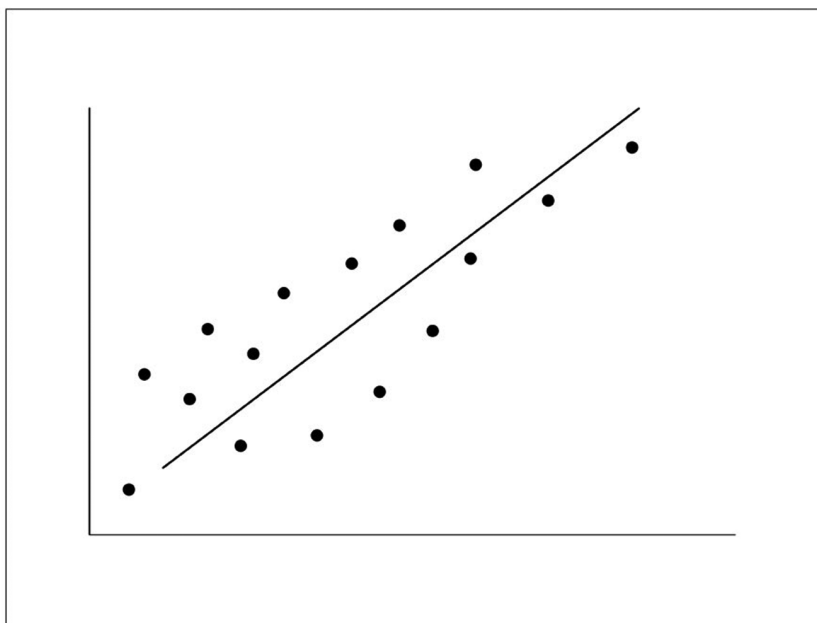
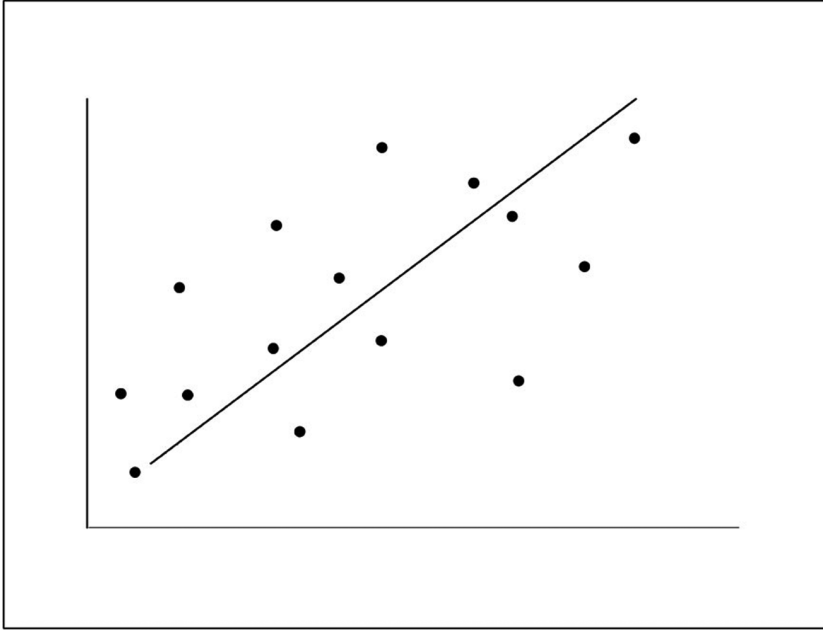


Exhibit B-2**Regression With Low R Squared**

B.03 The t statistic is interpreted very much like R squared. It is a measure of the degree to which each independent variable has a valid relationship with the dependent variable. A relatively small t statistic (although it is a matter of judgment, many auditors look for the t statistic to be greater than 1.3, which translates to an approximately 80 percent confidence level) is an indication of little or no relationship between the independent and dependent variable. When the t statistic is relatively low, the auditor might consider removing that variable from the regression.

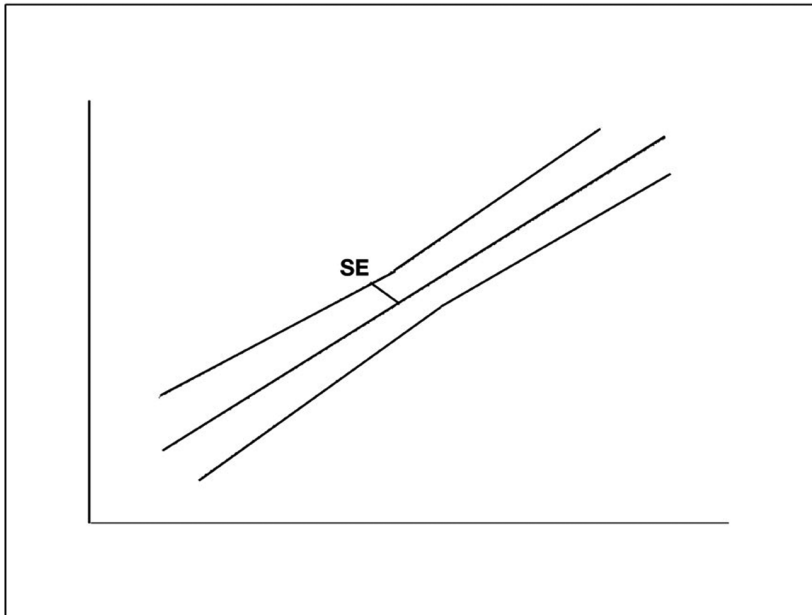
B.04 Also, the presence of a low t statistic on one or more of the independent variables is a common signal of what is called multicollinearity, which is present when two or more independent variables are highly correlated with each other. Correlation among variables, like R squared, means that a given variable tends to change predictably in the same (or opposite) direction for a given change in the other variable. Because there tend to be trends affecting many types of financial time-series data, it is common for accounting and operating data to be highly correlated. The effect of this condition is that the predictions of the regression might be less accurate. In particular, multicollinearity tends to cause understatement of the t statistics relating to the correlated independent variables. Thus, when the auditor has reason to believe that two or more of the independent variables are correlated, and the auditor observes relatively low t statistics, then the auditor might consider removing one or more of the correlated variables. One common approach in this situation is to perform a number of regression analyses with alternative combinations of the independent variables, and examine the different effects on R squared and the t statistics. To facilitate this, many software programs, such as Excel, can report the

"correlation matrix," which shows directly the degree of correlation between each pair of independent variables.

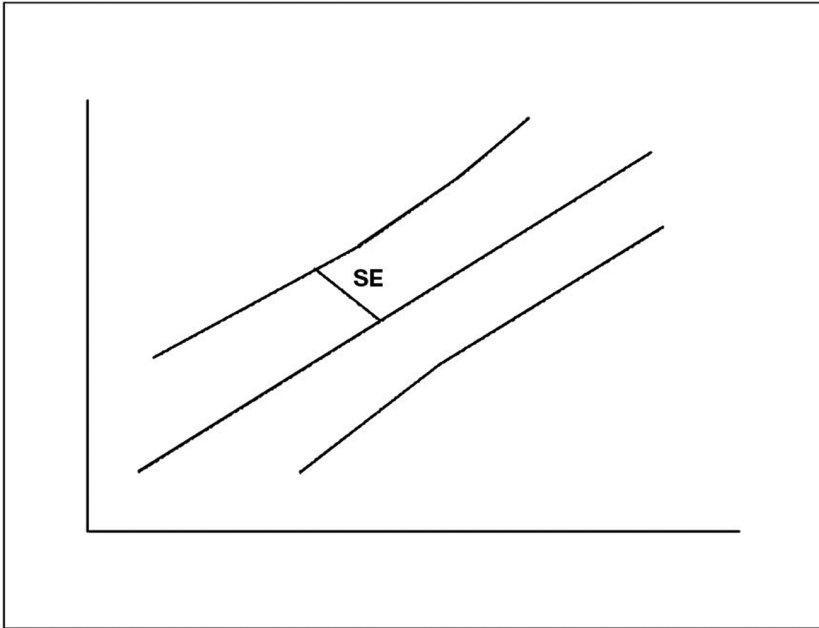
B.05 The standard error (SE) of the estimate is a measure of the accuracy of the regression's estimates. It is a measure of the range around the regression line in which auditors can be reasonably sure that the unknown actual value will fall. For example, if the auditor predicts that an amount will be \$4,500 for a regression having an SE of \$500, then the auditor can estimate with reasonable confidence that the unknown actual value lies somewhere in the range \$4,500 \pm (1.3 \times \$500), or \$3,850 to \$5,150.¹ Good and poor values for the standard error are illustrated in exhibits B-3 and B-4.

Exhibit B-3

Regression With Narrow (Good) Standard Error



¹ Multiplying the standard error by 1.3 in this calculation yields approximately an 80 percent confidence interval. If the auditor desires a different confidence level, a different multiplier is simply substituted in the calculation of the confidence interval. For example, a multiplier of 1.0 yields approximately a 67 percent confidence interval. For a 95 percent confidence level, the auditor would substitute a multiplier of 2.0 in the calculation.

Exhibit B-4**Regression With Wide (Poor) Standard Error**

B.06 Because it is used to measure a range, the SE is interpreted in terms of its relationship to the average amount of the dependent variable. If the SE is small relative to the dependent variable, the precision of the model can be assessed as relatively good. How small the SE value has to be relative to the mean of the dependent variable for a favorable precision evaluation is a matter of judgement, but often the threshold of 10 percent is suggested.

Appendix C

Financial Ratios

In the following table are several financial ratios that may be helpful while performing some of the analytical procedures contained in this guide. These financial ratios include liquidity, activity, and efficiency ratios.

<i>Financial Ratios</i>	<i>Formula</i>	<i>Explanation</i>
Current Ratio	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	Measures ability to meet short term obligations
Quick Ratio (or Acid Test Ratio)	$\frac{\text{Current Assets—Inventory}}{\text{Current Liabilities}}$	A more conservative measure of an entity's ability to meet short term obligations
Operating Cash Flows to Current Liabilities	$\frac{\text{Cash Provided by Operations}}{\text{Average Current Liabilities}}$	Liquidity calculation
Days Sales in Accounts Receivable	$\frac{\text{Net Accounts Receivable}}{\text{Net Sales}/360}$	Measures length of time average sales is a receivable
Allowance for Bad Credit as a % of Accounts Receivable	$\frac{\text{Allowance for Bad Debt}}{\text{Accounts Receivable}}$	Calculation is compared to prior periods and other comparable entities
Bad Debt Expense as a % of Net Sales	$\frac{\text{Bad Debt Expense}}{\text{Net Sales}}$	Calculation is compared to prior periods and other comparable entities
Inventory Turnover	$\frac{\text{Cost of Sales}}{\text{Inventory}}$	Activity ratio—indication of efficiency of operation
Fixed Asset Turnover	$\frac{\text{Net sales}}{\text{Average Fixed Assets}}$	Activity ratio
Receivable Turnover	$\frac{\text{Net Credit Sales}}{\text{Average Receivables}}$	Activity ratio
Net Sales to Inventory	$\frac{\text{Net sales}}{\text{Inventory}}$	Activity ratio
Days in Inventory	$\frac{\text{Inventory} \times (\text{Days in a Cycle})}{\text{Cost of Sales}}$	Identifies how many days of inventory is available

(continued)

<i>Financial Ratios</i>	<i>Formula</i>	<i>Explanation</i>
Accounts Payable to Net Sales	$\frac{\text{Accounts Payable} \times (\text{Days in a cycle})}{\text{Net Sales} \times (\text{Days in a year})}$	Compares A/P balance to net sales
Return on Total Assets	$\frac{\text{Earnings Before Income Tax (EBIT)}}{\text{Total Net Assets}}$	Identifies effective use of assets to generate earnings
Return on Net Worth	$\frac{\text{Net Income} \times (\text{Days in a year})}{\text{Net Worth} \times (\text{Days in a cycle})}$	Profitability measure
Return on Net Sales	$\frac{\text{Net Income}}{\text{Net Sales}}$	Profit margin
Net Sales to Accounts Receivable	$\frac{\text{Net Sales} \times (\text{Days in a year})}{\text{Net Accounts Receivable} \times (\text{Days in a cycle})}$	Identifies how many times Accounts Receivable will turn over per year of the operating cycle
Net Sales to Net Fixed Assets	$\frac{\text{Net Sales} \times (\text{Days in a year})}{\text{Fixed Assets} \times (\text{Days in a cycle})}$	Identifies efficiency of capital investment
Income Before Tax to Net Worth	$\frac{\text{Earnings Before Income Tax (EBIT)} \times (\text{Days in a year})}{\text{Net Worth} \times (\text{Days in a cycle})}$	Ratio of earnings to net worth per year
Gross Profit Percentage	$\frac{\text{Net Sales} - \text{Cost of Sales}}{\text{Net Sales}}$	Profitability calculation
Operating Expenses as a % of Net Sales	$\frac{\text{Operating Expenses}}{\text{Net Sales}}$	Efficiency calculation

Appendix D

Overview of Statements on Quality Control Standards

This appendix is nonauthoritative and is included for informational purposes only.

This appendix is a partial reproduction of chapter 1 of the AICPA practice aid *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, available at www.aicpa.org/interestareas/frc/pages/enhancingauditqualitypracticeaid.aspx.

This appendix highlights certain aspects of the quality control standards issued by the AICPA. If appropriate, readers should also refer to the quality control standards issued by the PCAOB, available at www.pcaobus.org/standards/qc/pages/default.aspx.

1.01 The objectives of a system of quality control are to provide a CPA firm with reasonable assurance¹ that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements, and that the firm or engagement partners issue reports that are appropriate in the circumstances. QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), addresses a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. That section is to be read in conjunction with the AICPA Code of Professional Conduct and other relevant ethical requirements.

1.02 A system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. The nature, extent, and formality of a firm's quality control policies and procedures will depend on various factors such as the firm's size; the number and operating characteristics of its offices; the degree of authority allowed to, and the knowledge and experience possessed by, firm personnel; and the nature and complexity of the firm's practice.

Communication of Quality Control Policies and Procedures

1.03 The firm should communicate its quality control policies and procedures to its personnel. Most firms will find it appropriate to communicate their policies and procedures in writing and distribute them, or make them available electronically, to all professional personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality

¹ The term *reasonable assurance*, which is defined as a high, but not absolute, level of assurance, is used because absolute assurance cannot be attained. Paragraph .53 of QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), states, "Any system of quality control has inherent limitations that can reduce its effectiveness."

- A requirement for each individual to be familiar with and to comply with these policies and procedures

Effective communication also includes procedures for personnel to communicate their views or concerns on quality control matters to the firm's management.

Elements of a System of Quality Control

1.04 A firm must establish and maintain a system of quality control. The firm's system of quality control should include policies and procedures that address each of the following elements of quality control identified in paragraph .17 of QC section 10:

- Leadership responsibilities for quality within the firm (the "tone at the top")
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Human resources
- Engagement performance
- Monitoring

1.05 The elements of quality control are interrelated. For example, a firm continually assesses client relationships to comply with relevant ethical requirements, including independence, integrity, and objectivity, and policies and procedures related to the acceptance and continuance of client relationships and specific engagements. Similarly, the human resources element of quality control encompasses criteria related to professional development, hiring, advancement, and assignment of firm personnel to engagements, all of which affect policies and procedures related to engagement performance. In addition, policies and procedures related to the monitoring element of quality control enable a firm to evaluate whether its policies and procedures for each of the other five elements of quality control are suitably designed and effectively applied.

1.06 Policies and procedures established by the firm related to each element are designed to achieve reasonable assurance with respect to the purpose of that element. Deficiencies in policies and procedures for an element may result in not achieving reasonable assurance with respect to the purpose of that element; however, the system of quality control, as a whole, may still be effective in providing the firm with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements and that the firm or engagement partners issue reports that are appropriate in the circumstances.

1.07 If a firm merges, acquires, sells, or otherwise changes a portion of its practice, the surviving firm evaluates and, as necessary, revises, implements, and maintains firm-wide quality control policies and procedures that are appropriate for the changed circumstances.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

1.08 The purpose of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. The firm should establish and maintain the following policies and procedures to achieve this purpose:

- Require the firm's leadership (managing partner, board of managing partners, CEO, or equivalent) to assume ultimate responsibility for the firm's system of quality control.
- Provide the firm with reasonable assurance that personnel assigned operational responsibility for the firm's quality control system have sufficient and appropriate experience and ability to identify and understand quality control issues and develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.

1.09 Establishing and maintaining the following policies and procedures assists firms in recognizing that the firm's business strategy is subject to the overarching requirement for the firm to achieve the objectives of the system of quality control in all the engagements that the firm performs:

- Assign management responsibilities so that commercial considerations do not override the quality of the work performed.
- Design policies and procedures addressing performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel to demonstrate the firm's overarching commitment to the objectives of the system of quality control.
- Devote sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.

Relevant Ethical Requirements

1.10 The purpose of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Require that personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the U.S. Government Accountability Office, and any other applicable regulators.
- Establish procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them.
- Establish procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit

or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.

- Require that the firm withdraw from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.
- Require written confirmation, at least annually, of compliance with the firm's policies and procedures on independence from all firm personnel required to be independent by relevant requirements.
- Establish procedures for confirming the independence of another firm or firm personnel in associated member firms who perform part of the engagement. This would apply to national firm personnel, foreign firm personnel, and foreign-associated firms.²
- Require the rotation of personnel for audit or attest engagements where regulatory or other authorities require such rotation after a specified period.

Acceptance and Continuance of Client Relationships and Specific Engagements

1.11 The purpose of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- is competent to perform the engagement and has the capabilities, including the time and resources, to do so;
- can comply with legal and relevant ethical requirements;
- has considered the client's integrity and does not have information that would lead it to conclude that the client lacks integrity; and
- has reached an understanding with the client regarding the services to be performed.

1.12 This assurance should be obtained before accepting an engagement with a new client, when deciding whether to continue an existing engagement,

² A *foreign-associated firm* is a firm domiciled outside of the United States and its territories that is a member of, correspondent with, or similarly associated with an international firm or international association of firms.

and when considering acceptance of a new engagement with an existing client. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Evaluate factors that have a bearing on management's integrity and consider the risk associated with providing professional services in particular circumstances.³
- Evaluate whether the engagement can be completed with professional competence; undertake only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluate, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.
- Obtain an understanding, preferably in writing, with the client regarding the services to be performed.
- Establish procedures on continuing an engagement and the client relationship, including procedures for dealing with information that would have caused the firm to decline an engagement if the information had been available earlier.
- Require documentation of how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.

Human Resources

1.13 The purpose of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (a) to perform its engagements in accordance with professional standards and regulatory and legal requirements, and (b) to enable the firm to issue reports that are appropriate in the circumstances. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Recruit and hire personnel of integrity who possess the characteristics that enable them to perform competently.
- Determine capabilities and competencies required for an engagement, especially for the engagement partner, based on the characteristics of the particular client, industry, and kind of service being performed. Specific competencies necessary for an engagement partner are discussed in paragraph .A27 of QC section 10.

³ Such considerations would include the risk of providing professional services to significant clients or to other clients for which the practitioner's objectivity or the appearance of independence may be impaired. In broad terms, the significance of a client to a member or a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. Examples of factors to consider in determining the significance of a client to an engagement partner, office, or practice unit include (a) the amount of time the partner, office, or practice unit devotes to the engagement, (b) the effect on the partner's stature within the firm as a result of his or her service to the client, (c) the manner in which the partner, office, or practice unit is compensated, or (d) the effect that losing the client would have on the partner, office, or practice unit.

- Determine the capabilities and competencies possessed by personnel.
- Assign the responsibility for each engagement to an engagement partner.
- Assign personnel based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed.
- Have personnel participate in general and industry-specific continuing professional education and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable continuing professional education requirements of the AICPA, state boards of accountancy, and other regulators.
- Select for advancement only those individuals who have the qualifications necessary to fulfill the responsibilities they will be called on to assume.

Engagement Performance

1.14 The purpose of the engagement performance element of quality control is to provide the firm with reasonable assurance (a) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements, and (b) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed.

1.15 Establishing and maintaining policies such as the following assist the firm in obtaining the assurance required relating to the engagement performance element of quality control:

- Plan all engagements to meet professional, regulatory, and the firm's requirements.
- Perform work and issue reports and other communications that meet professional, regulatory, and the firm's requirements.
- Require that work performed by other team members be reviewed by qualified engagement team members, which may include the engagement partner, on a timely basis.
- Require the engagement team to complete the assembly of final engagement files on a timely basis.
- Establish procedures to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.
- Require the retention of engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.

- Require that
 - consultation take place when appropriate (for example, when dealing with complex, unusual, unfamiliar, difficult, or contentious issues);
 - sufficient and appropriate resources be available to enable appropriate consultation to take place;
 - all the relevant facts known to the engagement team be provided to those consulted;
 - the nature, scope, and conclusions of such consultations be documented; and
 - the conclusions resulting from such consultations be implemented.
- Require that
 - differences of opinion be dealt with and resolved;
 - conclusions reached are documented and implemented; and
 - the report not be released until the matter is resolved.
- Require that
 - all engagements be evaluated against the criteria for determining whether an engagement quality control review should be performed;
 - an engagement quality control review be performed for all engagements that meet the criteria; and
 - the review be completed before the report is released.
- Establish procedures addressing the nature, timing, extent, and documentation of the engagement quality control review.
- Establish criteria for the eligibility of engagement quality control reviewers.

Monitoring

1.16 The purpose of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented

- Whether the firm's quality control policies and procedures have been operating effectively so that reports issued by the firm are appropriate in the circumstances

1.17 Establishing and maintaining policies such as the following assist the firm in obtaining the assurance required relating to the monitoring element of quality control:

- Assign responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility.
- Assign performance of the monitoring process to competent individuals.
- Require the performance of monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures. Monitoring procedures consist of the following:
 - Review of selected administrative and personnel records pertaining to the quality control elements.
 - Review of engagement documentation, reports, and clients' financial statements.
 - Summarization of the findings from the monitoring procedures, at least annually, and consideration of the systemic causes of findings that indicate that improvements are needed.
 - Determination of any corrective actions to be taken or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures.
 - Communication of the identified findings to appropriate firm management personnel.
 - Consideration of findings by appropriate firm management personnel who should also determine that any actions necessary, including necessary modifications to the quality control system, are taken on a timely basis.
 - Assessment of
 - the appropriateness of the firm's guidance materials and any practice aids;
 - new developments in professional standards and regulatory and legal requirements and how they are reflected in the firm's policies and procedures where appropriate;
 - compliance with policies and procedures on independence;
 - the effectiveness of continuing professional development, including training;

- decisions related to acceptance and continuance of client relationships and specific engagements; and
 - firm personnel's understanding of the firm's quality control policies and procedures and implementation thereof.
- Communicate at least annually, to relevant engagement partners and other appropriate personnel, deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.
 - Communicate the results of the monitoring of its quality control system process to relevant firm personnel at least annually.
 - Establish procedures designed to provide the firm with reasonable assurance that it deals appropriately with the following:
 - Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements.
 - Allegations of noncompliance with the firm's system of quality control.
 - Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations.

This includes establishing clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisal and documenting complaints and allegations and the responses to them.

- Require appropriate documentation to provide evidence of the operation of each element of its system of quality control. The form and content of documentation evidencing the operation of each of the elements of the system of quality control is a matter of judgment and depends on a number of factors, including the following, for example:
 - The size of the firm and the number of offices.
 - The nature and complexity of the firm's practice and organization.
- Require retention of documentation providing evidence of the operation of the system of quality control for a period of time sufficient to permit those performing monitoring procedures and peer review to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

1.18 Some of the monitoring procedures discussed in the previous list may be accomplished through the performance of the following:

- Engagement quality control review

- Review of engagement documentation, reports, and clients' financial statements for selected engagements after the report release date
- Inspection⁴ procedures

Documentation of Quality Control Policies and Procedures

1.19 The firm should document each element of its system of quality control. The extent of the documentation will depend on the size, structure, and nature of the firm's practice. Documentation may be as simple as a checklist of the firm's policies and procedures or as extensive as practice manuals.

⁴ *Inspection* is a retrospective evaluation of the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures, and the extent of the firm's compliance with them. Although monitoring procedures are meant to be ongoing, they may include inspection procedures performed at a fixed point in time. Monitoring is a broad concept; inspection is one specific type of monitoring procedure.

Appendix E

Schedule of Changes Made to the Text From the Previous Edition

As of October 1, 2017

This schedule of changes identifies areas in the text and footnotes of this guide that have changed since the previous edition. Entries in the table of this appendix reflect current numbering, lettering (including that in appendix names), and character designations that resulted from the renumbering or re-ordering that occurred in the updating of this guide.

<i>Reference</i>	<i>Change</i>
Preface	Updated.
Former Update 1-1 before paragraph 1.01	Deleted for passage of time.
Former Update 2-1 before paragraph 2.01	Deleted for passage of time.
Former chapter 3	Relocated to appendix A.
Former appendix A	Relocated to appendix B.
Former appendix B	Relocated to appendix C.
Former appendix C	Deleted for passage of time.

Index of Pronouncements and Other Technical Guidance

A

<i>Title</i>	<i>Paragraphs</i>
AU-C Section	
240, <i>Consideration of Fraud in a Financial Statement Audit</i>	2.42, Appendix A at A.71
315, <i>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</i>	1.04–.05, Appendix A at A.21
330, <i>Performing Audit Procedures in Response to Assessed Risks and Evaluation of the Audit Evidence Obtained</i>	1.04, 1.08, 2.19, 2.30
450, <i>Evaluation of Misstatements Identified During the Audit</i>	1.48, 2.28, Appendix A at A.25, Appendix A at A.34, Appendix A at A.47
500, <i>Audit Evidence</i>	1.08
520, <i>Analytical Procedures</i>	1.01, 1.03–.04, 1.16, 2.05, Appendix A at A.21, Appendix A at A.24, Appendix A at A.33, Appendix A at A.46
Audit Guides	
<i>Audit Sampling</i>	2.23

P

<i>Title</i>	<i>Paragraphs</i>
PCAOB AS	
2201, <i>An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements</i>	2.42, Appendix A at A.71
2401, <i>Consideration of Fraud in a Financial Statement Audit</i>	2.42, Appendix A at A.71

Subject Index

A

AGGREGATION OF DATA

- Disaggregation's effect on precision of expectation 1.22
- Level of assurance, impact on 2.04–05

ANALYTICAL PROCEDURES 1.01–48

- Concepts and definition 1.03–13
- Effectiveness factors 1.17
- Evaluation phase 1.47–48
- Expectation formation phase 1.16–40
- Generally 1.01–02, 1.14–15
- Identification and investigation phases 1.41–46
- On the Go Stores case study Appendix A
- Purpose of 1.02, 2.29–39
- Questions and answers 2.01–42

ASSERTIONS. *See also nature of account or assertion*

- Level of assurance in testing 1.13

ASSURANCE, LEVEL OF. *See level of assurance*

ATTEST ENGAGEMENT, SUBSTANTIVE

- ANALYTICAL PROCEDURES IN 2.31,
- 2.33

AUDIT ENGAGEMENT, SUBSTANTIVE

- ANALYTICAL PROCEDURES COMPARED TO OTHER ENGAGEMENT TYPES 2.31–32

AUDIT EVIDENCE

- Corroborating explanations with 1.45–46
- Internal control 2.29–30
- Level of assurance 1.13
- Purpose of analytical procedures and 1.02
- Significant risk 2.18–19

AUDIT PLANNING

- Adjustment to working trial balance situation 2.34–35
- Applying analytical procedures during 1.05
- Expectation formation during 2.14–15
- Purpose of analytical procedures and 1.02

AUDIT RISK MODEL, RELATIONSHIP OF ANALYTICAL PROCEDURES

- TO 2.16–23

C

CONTROL RISK 2.20–21

CONTROLS. *See internal control*

D

DATA. *See aggregation of data; reliability and other characteristics of data*

DETECTION RISK 1.13

E

EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING 2.29–30

EVALUATION PHASE

- Defined 1.15
- Differences between expected and recorded amounts 2.27–28
- Generally 1.03
- Procedures during 1.47–48, 2.15
- Reliability of data 1.08

EVIDENCE. *See audit evidence*

EXPECTATION-FORMATION PHASE,

- DEFINED 1.03, 1.14

EXPECTATIONS. *See also precision of expectation*

- Analyzing amount of difference from actual data 1.09
- Auditing purpose of 1.04
- Defined 1.10
- Formation of 1.03, 1.08, 1.10, 1.16–40
- Methods in case study Appendix A

EXPLICIT OR IMPLICIT EXPECTATION,

- IMPACT ON METHOD USED 1.40

EXTERNAL DATA, IMPACT ON EXPECTATION

- METHOD USED 1.40

F

FINANCIAL RATIOS. *See also ratio*

- analysis Appendix C

FINANCIAL VERSUS NONFINANCIAL DATA, AS RELIABILITY OF DATA FACTOR 1.23

FRAUD CONSIDERATION

- Analytical procedures alone as insufficient to determine presence of fraud 2.40–42
- Regression analysis and Appendix A at A.71–73
- Tests of controls 1.08

I

IDENTIFICATION PHASE 1.15, 1.41

IMPLICIT OR EXPLICIT EXPECTATION,

- IMPACT ON METHOD USED 1.40

INHERENT RISK, IMPACT ON USE OF

- ANALYTICAL PROCEDURES 2.16–17

INTERNAL CONTROL

- Analytical procedures' evidence on effectiveness of 2.29–30
- As reliability of data factor 1.23
- Control risk 2.20–21

INTERNAL CONTROL—continued

- Management override of controls, risk of 1.08
- Tests of controls 1.08, 2.20–21

INTERNAL VERSUS OUTSIDE DATA AND DEGREE OF INDEPENDENCE 1.23**INVESTIGATION PHASE**

- Defined 1.15
- Further investigation, criteria for 2.24–25
- Generally 1.03
- Misstatement assessment 1.42–43, 2.27–28
- Procedures during 1.41–46

L**LEVEL OF ASSURANCE**

- Attest distinguished from audit engagement 2.33
- Data aggregation's effect on 2.04–05
- Data reliability's effect on 2.06–07
- Defined 1.11–12
- Expectation method and 1.25
- Factors determining 2.02–03
- In testing assertions 1.13
- Precision of expectation as key to 1.16
- Review distinguished from audit engagement 2.32

M**MATERIAL MISSTATEMENT, RISK OF. See also fraud consideration**

- Analytical procedures' role in assessing 2.22–23, 2.42
- Audit planning consideration 1.05
- Evaluating difference between expected and recorded amounts 1.47–48, 2.15
- Increasing level of assurance in design of substantive procedures 1.09
- Substantive testing phase 1.07–08
- Trend analysis and 1.28

MATERIALITY

- Amount of difference between expected and recorded amounts 1.09, 2.28
- Analytical procedures process 1.15

METHODS USED TO DEVELOP EXPECTATIONS, RELATIONSHIP TO PRECISION OF EXPECTATION 1.37–40, Table 1-1 at 1.40**MISSTATEMENTS. See also material misstatement, risk of**

- Determining materiality of 1.48
- Identification of 1.02, 1.10

MISSTATEMENTS—continued

- Investigating differences in expected versus recorded amounts 1.42–43, 2.27–28
- Planning materiality 2.09

N**NATURE OF ACCOUNT OR ASSERTION**

- As effectiveness factor in analytical procedures 1.17
- Case study Appendix A at A.08
- Expectation formation 1.18–20
- Precision of expectation 1.11, 1.18–20

NONFINANCIAL VERSUS FINANCIAL DATA, AS RELIABILITY OF DATA FACTOR 1.23**NUMBER OF PREDICTORS, IMPACT ON EXPECTATION METHOD USED 1.40****O****ON THE GO STORES CASE STUDY Appendix A****OPERATING DATA, IMPACT ON EXPECTATION METHOD USED 1.40****OUTSIDE VERSUS INTERNAL DATA AND DEGREE OF INDEPENDENCE 1.23****P****PERFORMANCE MATERIALITY 1.09****PLANNING. See audit planning****PLANNING MATERIALITY 2.08–09****PRECISION OF EXPECTATION**

- As effectiveness factor in analytical procedures 1.17
- Defined 1.11–12
- Importance of 1.16
- Inherent precision of expectation method used 1.25–36
- Inherent risk assessment and 2.16–17
- Investigation phase 1.42–43
- Nature of account or assertion 1.11, 1.18–20
- Questions and answers 2.02–15
- Relationship to methods used to develop expectations 1.37–40, Table 1-1 at 1.40
- Reliability and other characteristics of data 1.21–24
- Source of information as determiner of ... 1.10

PROFESSIONAL JUDGMENT

- Expectation formation method 1.25
- Procedures to use 1.02

Q**QUALITY CONTROL STANDARDS Appendix D**

R

RATIO ANALYSIS

- Case study Appendix A at A.26–35
- Design and performance of analytical procedures requirements 1.08
- Explicit or implicit expectation 1.40
- External data, impact on expectation method used 1.40
- In substantive testing 2.12–13
- Inherent precision of 1.30–32, 1.39
- Number of predictors, impact on expectation method used 1.40

REASONABLENESS TESTING

- Case study Appendix A at A.74–75
- Explicit or implicit expectation 1.40
- External data, impact on expectation method used 1.40
- In substantive testing 2.12–13
- Inherent precision of 1.33–34
- Number of predictors, impact on expectation method used 1.40

REGRESSION ANALYSIS

- Benefits in substantive procedure ... 2.10–11
- Case study Appendix A at A.49–69
- Explicit or implicit expectation 1.40
- External data, impact on expectation method used 1.40
- Fraud detection Appendix A at A.71–73
- Inherent precision of 1.35–36
- Measures of precision for Appendix B
- Number of predictors, impact on expectation method used 1.40
- Precision of expectation, effect on 1.38
- Review engagements Appendix A at A.70
- Statistical power, impact on expectation method used 1.40

RELIABILITY AND OTHER CHARACTERISTICS OF DATA

- As effectiveness factor in analytical procedures 1.17
- Evaluation phase 1.08
- Expectation formation 1.21–24
- Level of assurance, effect on 2.06–07

REVIEW ENGAGEMENT

- Regression analysis in Appendix A at A.70
- Substantive analytical procedures in 2.31–33

REVIEW STAGE OF AUDIT

- Expectation formation during 2.14–15
- Objective of analytical procedures in 1.02

RISK AND RISK ASSESSMENT. See also material misstatement, risk of

- Analytical procedures as risk assessment 1.04–05
- Audit risk model 2.16–23
- Control risk 2.20–21
- Detection risk 1.13
- Inherent risk 2.16–17
- Significant risk 2.18–19

S

SCHEDULE OF CHANGES MADE TO TEXT

FROM PREVIOUS EDITION ... Appendix E

SIGNIFICANT RISK 2.18–19**SUBSTANTIVE ANALYTICAL PROCEDURES**

- Auditor's use of 1.04
- Corroborating explanations for differences 1.45–46
- Designing and performing 1.08
- Effectiveness of internal control over financial reporting 2.29–30
- Expectation formation 2.14–15
- Ratio analysis 2.12–13
- Reasonableness testing 2.12–13
- Regression analysis 2.10–11
- Relationship among accounts and design of 2.36–37
- Risk of material misstatement 1.07–08
- Substantive testing stage of audit 1.02
- Trend analysis in 2.12–13
- Type of engagement and 2.31–33

T

TESTING OF CONTROLS 1.08, 2.20–21**TREND ANALYSIS**

- Case study Appendix A at A.11–25
- Explicit or implicit expectation 1.40
- Inherent precision of 1.26–29
- Number of predictors, impact on expectation method used 1.40
- Operating data, impact on expectation method used 1.40
- Precision of expectation, effect on 1.37

U

UNCORRECTED MISSTATEMENTS, EVALUATING 1.48, 2.28**UNDERSTANDING OF THE ENTITY AND ITS ENVIRONMENT 1.06**

