STAFF QUESTIONS AND ANSWERS

IAASB INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD

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# AUDITOR CONSIDERATIONS REGARDING SIGNIFICANT UNUSUAL OR HIGHLY COMPLEX TRANSACTIONS

This Questions & Answers (Q&A) publication is issued by staff of the International Auditing and Assurance Standards Board (IAASB) to highlight considerations in the International Standards on Auditing (ISAs) that are relevant to auditing transactions that are significant unusual or highly complex, judged in the light of the auditor's understanding of the entity and its environment and other information obtained during the audit. Because of their nature, these transactions may give rise to risks of material misstatement of the financial statements and, accordingly, may merit heightened attention by auditors. Auditors of the financial statements of entities of all sizes may find this Q&A helpful in addressing the audit of such transactions.

This publication has been developed in response to specific requests for information on how the ISAs deal with this particular topic. It does not amend or override the ISAs,[1] the texts of which alone are authoritative. Reading this Q&A is not a substitute for reading the ISAs. The Q&A is not meant to be exhaustive and reference to the ISAs themselves should always be made. This publication does not constitute an authoritative or official pronouncement of the IAASB.

## BACKGROUND

Material misstatement of financial statements, including fraudulent financial reporting, can arise from significant unusual or highly complex transactions, especially those that pose difficult "substance over form" questions, such as transactions not in the ordinary course of business undertaken with related parties. The ISAs give particular attention to the accounting for and disclosure of such transactions in the context of the auditor's identification and assessment of risks of material misstatement, whether due to error or fraud, and the auditor's responses thereto.

The following Questions and Answers highlight requirements and application and other explanatory material in the ISAs that focus on specific audit considerations relating to significant unusual or highly complex transactions, including significant transactions outside the normal course of business and those occurring at or near period end.

While certain requirements and application and other explanatory material in particular are highlighted, this publication does not reproduce all of the ISA provisions that are relevant to the auditor's responsibilities in connection with auditing such transactions. The proper application of the entirety of the risk identification, assessment and response standards (ISAs 240, 315 and 330,[2] for example) has bearing on the conclusions the auditor draws from the evidence obtained in forming an opinion on the financial statements. This is equally true for other ISAs, ranging from ISA 200 to ISA 540 and ISA 550, to ISA 720.[3] The fact that any particular ISA does not make specific reference to a transaction as being significant, unusual, or highly complex does not limit its general applicability to such transactions.

1 All references to ISAs in this publication are to the clarified ISAs, which are in effect for audits of financial statements for periods beginning on or after December 15, 2009.

2 ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*; ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*; and ISA 330, *The Auditor's Responses to Assessed Risks*

3 ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*; ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*; ISA 550, *Related Parties*; and ISA 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*

## QUESTIONS AND ANSWERS

**Q1.** ***What considerations in the ISAs are relevant in approaching the audit of significant unusual or highly complex transactions?***

The ISAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of an audit and, among other things, identify, assess and respond to risks of material misstatement, whether due to fraud or error.[4] Accordingly, the auditor plans and performs an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.[5] Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of overlooking unusual circumstances.[6]

*Identification and Assessment of Risks of Material Misstatement*

The auditor identifies and assesses the risks of material misstatement by performing risk assessment procedures designed to obtain the required understanding of the entity and its environment, including the entity's internal control. That understanding includes:[7]

- The types of investments that the entity is making, including investments in special-purpose entities;
- The entity's selection and application of accounting policies, and an evaluation of whether they are appropriate for the entity's business;
- The entity's objectives and strategies, including related business risks that may result in risks of material misstatement; and
- The entity's risk assessment process.

In identifying risks of material misstatement, the engagement partner and other key engagement team members are required to discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the financial reporting framework to the entity's facts and circumstances.[8] That discussion places particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur[9] – for example, consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.[10]

The auditor is required to evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures may indicate risks of material misstatement due to fraud.[11] Amongst other matters when identifying and assessing such risks, the auditor is required to, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks.[12]

4 ISA 200, paragraph 7

5 ISA 200, paragraph 15

6 ISA 200, paragraph A19

7 ISA 315, paragraphs 11 and 15

8 ISA 315, paragraph 10

9 ISA 240, paragraph 15

10 ISA 240, paragraph A11

11 ISA 240, paragraph 22

12 ISA 240, paragraph 26

The auditor is also required to:

- Evaluate whether information obtained about the entity indicates that one or more fraud risk factors are present.[13] Fraud risk factors include, for example:
    - Significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm; and
    - Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions, as these provide opportunities to engage in fraudulent financial reporting;[14]
- Inquire of management and others within the entity as appropriate about the existence or suspicion of fraud, including, for example, employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees;[15]
- Inquire of management and others within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to:
    - Authorize and approve significant transactions and arrangements with related parties; and
    - Authorize and approve significant transactions and arrangements outside the normal course of business;[16] and
- If the auditor identifies significant transactions outside the normal course of business, inquire of management about the nature of these transactions and whether related parties could be involved.[17]

In relation to journal entries, the auditor is required to:

- Obtain an understanding of controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments;[18] and
- Design and perform audit procedures to test the appropriateness of journal entries and other adjustments made in the preparation of the financial statements. In doing so, the auditor:[19]
    - Inquires of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
    - Selects journal entries and other adjustments made at the end of a reporting period; and
    - Considers the need to test journal entries and other adjustments throughout the period.

As part of the auditor's risk assessment, the auditor is required to determine whether any of the risks identified are, in the auditor's judgment, a significant risk.[20] This determination includes considering, amongst other matters:[21]

13 ISA 240, paragraph 24

14 ISA 240, Appendix 1

15 ISA 240, paragraphs 18 and A16

16 ISA 550, paragraph 14

17 ISA 550, paragraph 16

18 ISA 315, paragraph 18

19 ISA 240, paragraph 32

20 ISA 315, paragraph 27

21 ISA 315, paragraph 28

- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual;
- The complexity of transactions;
- Whether the risk involves significant transactions with related parties; and
- The degree of subjectivity in measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty.

The auditor is also required to treat identified significant related party transactions outside the entity's normal course of business as giving rise to significant risks.[22]

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Management override of controls or other inappropriate involvement by management in the financial reporting process may involve such techniques as omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period, or engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.[23] The auditor is required to treat the risk of management override of controls as a risk of material misstatement due to fraud and thus a significant risk.[24]

*Responses to Assessed Risks*

The auditor is required to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level, and to design and perform further audit procedures whose nature, timing, and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.[25]

In determining overall responses to address the assessed risks, the auditor is required to evaluate whether the entity's selection and application of accounting policies, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings.[26]

In responding to the assessed risks, the auditor is required to obtain more persuasive audit evidence if the auditor's assessment of risk is higher.[27] For example, the auditor may place more emphasis on obtaining evidence directly from third parties or obtaining corroborating evidence from a number of independent sources.[28] Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error.[29]

22 ISA 550, paragraph 18

23 ISA 240, paragraph A4

24 ISA 240, paragraph 31

25 ISA 330, paragraphs 5 and 6

26 ISA 240, paragraph 29

27 ISA 330, paragraph 7(b)

28 ISA 505, *External Confirmations*, paragraph 3

29 ISA 330, paragraph A53

In all cases for significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor is required to evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.[30] Indicators that may suggest that significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting include:[31]

- The form of such transactions appears overly complex.
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Transactions that involve non-consolidated related parties, including special purpose entities, have not been properly reviewed or approved by those charged with governance of the entity.
- The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

The auditor is similarly required to evaluate the business rationale (or lack thereof) of significant related party transactions outside the entity's normal course of business.[32] In doing so, in addition to the considerations noted above, the auditor may consider whether the transaction has unusual terms, lacks an apparent logical business reason for its occurrence, or is processed in an unusual manner; and whether management has discussed the nature of, and accounting for, such a transaction with those charged with governance.[33]

The auditor is required to review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias.[34] The auditor is required to evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud; if so, the auditor is required to reevaluate the accounting estimates taken as a whole.[35]

The auditor is required to evaluate whether analytical procedures that are performed near the end of the audit, when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity, indicate a previously unrecognized risk of material misstatement due to fraud.[36] Unusual relationships involving year-end revenue and income are particularly relevant. These might include, for example: uncharacteristically large amounts of income being reported in the last few weeks of the reporting period or unusual transactions; or income that is inconsistent with trends in cash flow from operations.[37]

30 ISA 240, paragraph 32

31 ISA 240, paragraph A48

32 ISA 550, paragraph 23

33 ISA 550, paragraph A38

34 ISA 540, paragraph 21

35 ISA 240, paragraph 32

36 ISA 240, paragraph 34

37 ISA 240, paragraph A50

**Q2.** ***When forming an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained, what considerations in the ISAs are relevant in relation to significant unusual or highly complex transactions?***

The auditor's evaluation of whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework is required to include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.[38] In particular, the auditor's evaluation is required to include whether, in view of the requirements of the applicable financial reporting framework:[39]

- The financial statements adequately disclose the significant accounting policies selected and applied;
- The accounting policies selected and applied are consistent with the financial reporting framework and are appropriate;
- The information presented in the financial statements is relevant, reliable, comparable, and understandable; and
- The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.

When the financial statements are prepared in accordance with a fair presentation framework, the auditor's evaluation as to whether the financial statements achieve fair presentation is required to include consideration of whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.[40]

Evaluating related party disclosures includes considering whether the facts and circumstances of the entity's related party relationships and transactions have been appropriately summarized and presented so that the disclosures are understandable. Disclosures of related party transactions may not be understandable if the business rationale and the effects of the transactions on the financial statements are unclear or misstated; or key terms, conditions, or other important elements of the transactions necessary for understanding them are not appropriately disclosed.[41]

For accounting estimates that give rise to significant risks, the auditor is required to evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework.[42]

***Q3. How do the ISAs guide the auditor in the auditor's communication with those charged with governance when dealing with such transactions?***

The auditor is required to communicate with those charged with governance the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor is required to explain to those charged with

38 ISA 700, *Forming an Opinion and Reporting on Financial Statements*, paragraph 12

39 ISA 700, paragraph 13

40 ISA 700, paragraph 14

41 ISA 550, paragraph A47

42 ISA 540, paragraph 20

governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity.[43]

The communication required may include such matters as:[44]

- The appropriateness of the accounting policies to the particular circumstances of the entity, having regard to the need to balance the cost of providing information with the likely benefit to users of the entity's financial statements.
- The effect of the timing of transactions in relation to the period in which they are recorded.
- Indicators of possible management bias.
- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures.
- The overall neutrality, consistency and clarity of the disclosures in the financial statements.
- The potential effect on the financial statements of significant risks, exposures and uncertainties that are disclosed in the financial statements.
- The extent to which the financial statements are affected by unusual transactions, including non-recurring amounts recognized during the period, and the extent to which such transactions are separately disclosed in the financial statements.
- The factors affecting asset and liability carrying values.

The auditor is also required to communicate with those charged with governance matters arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.[45]

In addition to communicating with those charged with governance, the auditor is required to determine whether the auditor has a responsibility to communicate to regulatory and enforcement authorities:

- The occurrence or suspicion of fraud;[46] and
- Identified or suspected non-compliance with laws and regulations.[47]

**Q4. *What general considerations in the ISAs are relevant in relation to audit documentation, quality control, and interim reviews of financial statements when dealing with such transactions?***

ISA 230,[48] together with specific requirements in other ISAs, deals with the auditor's documentation responsibilities. In particular, the auditor is required to prepare sufficient audit documentation to enable an experienced auditor, having no previous connection with the audit, to understand significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.[49]

43 ISA 260, *Communication with Those Charged with Governance*, paragraph 16

44 ISA 260, Appendix 2

45 ISA 260, paragraph 16

46 ISA 240, paragraph 43

47 ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph 28

48 ISA 230, *Audit Documentation*

49 ISA 230, paragraph 8

ISQC 1[50] and ISA 220[51] deal with quality control requirements at the firm and engagement levels respectively. These standards address, amongst other matters, consultation on difficult or contentious matters, and the responsibilities relating to engagement quality control review.

As applicable, ISRE 2410[52] establishes the responsibilities of the auditor when engaged to review interim financial information of an audit client. Amongst other matters, ISRE 2410 indicates that the auditor ordinarily inquires of members of management responsible for financial and accounting matters, and others as appropriate, about unusual or complex transactions that may have affected the interim financial information and significant transactions occurring in the last several days of the interim period or the first several days of the next interim period.[53]

## ABOUT THE IAASB

The IAASB develops auditing and assurance standards and guidance for use by all professional accountants under a shared standard-setting process involving the Public Interest Oversight Board, which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance. For more information about the IAASB, visit its home page at **http://www.iaasb.org**.

## KEY CONTACT

James Gunn, IAASB Technical Director (**jamesgunn@ifac.org**)

50 ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

51 ISA 220, *Quality Control for an Audit of Financial Statements*

52 ISRE 2410, *Reviews of Interim Financial Information Performed by the Independent Auditor of the Entity*

53 ISRE 2410, paragraph 21

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INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD
**International Federation of Accountants**
545 Fifth Avenue, 14th Floor, New York, NY 10017 USA
Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org email: pr@ifac.org