

May 5, 2010

Mr. Mike Glynn
AICPA
1211 Avenue of the Americas
New York, N.Y. 10036-8775

By e-mail: mglynn@aicpa.org

Re: Proposed Statement on Auditing Standards, *Analytical Procedures* (Redrafted)

Dear Mr. Glynn:

The New York State Society of Certified Public Accountants, representing 28,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the above captioned exposure draft.

The NYSSCPA's Auditing Standards Committee deliberated the exposure draft and prepared the attached comments. If you would like additional discussion with us, please contact Robert N. Waxman, Chair of the Auditing Standards Committee at (212) 755-3400, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,



David J. Moynihan
President

Attachment

**NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS**

**COMMENTS ON
PROPOSED STATEMENTS ON AUDITING STANDARDS,
*ANALYTICAL PROCEDURES (REDRAFTED)***

May 5, 2010

Principal Drafter

**John F. Georger, Jr.
Neal B. Hitzig**

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New York State Society of Certified Public Accountants
Auditing Standards Committee

Comments on
Proposed Statements on Auditing Standards, *Analytical Procedures* (Redrafted)

The New York State Society of Certified Public Accountants welcomes the opportunity to comment on the AICPA Auditing Standards Board's (ASB) proposed statement, *Analytical Procedures* (Redrafted).

We support the ASB's efforts to improve the clarity and reduce the complexity of auditing standards as well as its ongoing goal to converge the proposed standards with International Standards on Auditing (ISAs).

Responses to specific questions

1. Are the objectives of the auditor appropriate?

Yes, the objectives of the auditor are appropriate.

2. Are the revisions made to converge the existing standards with ISA 520 appropriate?

The convergence revisions are reasonable.

3. Are the differences between the proposed SAS and ISA 520 identified in the exhibit, and other language changes, appropriate?

We believe that ISA 520 (as well as extant U.S. literature) fails to address serious risk-related issues associated with reliance on analytical procedures as substantive tests. We discuss these below.

4. Have considerations for audits of smaller, less complex entities and governmental entities been dealt with appropriately?

Although the Exposure Draft (ED) does address considerations for governmental entities in paragraph A15, we find no guidance that is pertinent to smaller or less complex entities. Because internal control may be weak or nonexistent in a smaller entity, reliance on analytical procedures during the substantive testing stage of the audit may be problematic.

General comments

Much of the guidance presented in the ED is appropriate and useful. However, our major concern is that, by focusing on deviations from expectation as the basis for an auditor's decision regarding the occurrence of material misstatement, the ED fails to consider that conforming to expectations cannot, by itself, be reliably taken to mean that such a misstatement does not exist. Par. A19 partially addresses this issue, although disaggregation is unlikely to be effective if the data under audit is fraudulently manipulated.

Analytical procedures might be better at detecting errors than they are at detecting fraud. Fraud detection is problematic because management might be able to manipulate data to conform to expectations. WorldCom provided an important example of the inherent weakness in analytical procedures. In his testimony before the U.S. House Committee on Financial Services, Melvin Dick, Arthur Andersen's former senior global managing partner for technology, media, and communications stated:

[W]e performed numerous analytical procedures at various financial statement line items, including line costs, revenues in and plant and service, in order to determine if there were significant variations that required additional work. We also utilized sophisticated auditing software to study WorldCom's financial statement line items, which did not trigger any indication that there was a need for additional work.

[Remarks of Melvin Dick. United States House of Representatives, Committee on Financial Services. July 8, 2002.

<http://f11.findlaw.com/news.findlaw.com/hdocs/docs/worldcom/70802mdtst.pdf>]

There is no reason to believe that Andersen's procedures were anything other than the most sophisticated in the Profession. Yet, those procedures failed to detect fraud that totaled more than \$10 billion.

AU 316. *Consideration of Fraud in a Financial Statement Audit*, alludes to the foregoing in Par. 316.31, in which reference is made to concealment. Nevertheless, even that admonition is vague. The fraud risk factors referred to therein do not specifically refer to the auditor's assumed relationship, nor do they require the auditor to consider the risk that the assumed relationship might be materially misleading. (We note, however, that AU316 also identifies other considerations related to fraud besides analytic procedures that an auditor should take into account when accessing the risk of material misstatement.)

Analytical procedures are corroborative, as the ED states; however, many academic researchers have made the mistake of assuming that statistical measures of detection risk can be obtained from analytical procedures (as they can from statistical samples). An example is *The error detection of structural analytical procedures: A simulation study*, by Chen and Leitch (*Auditing*. Sarasota: Fall 1998. Vol. 17, Iss. 2; pg. 36-70). The authors base their conclusions on the ability of a specified analytical to detect errors seeded in the data that formed the basis for the model. If the assumed relationship is known to be the correct relationship, its effectiveness can be measured. In

reality, the actual relationship is not known, yet, auditors make no risk assessment associated with making an incorrect assumption. All the analytical procedures risks are based on the probabilities associated with deviation in data from the assumed relationship's predictions. They base this on the identification and measurement of deviations from expectation, given the auditor-specified analytical relationship. There is no measure of the risk that the underlying relationship is itself incorrect.

A key component of audit risk has been completely ignored; the risk of basing audit decisions on an inappropriate relationship between the variables involved. There is an unstated risk that the relationship between the predictive variable[s] and the variable under examination is materially misleading. This risk coexists with the risk that observed behavior in the data under examination fail to indicate the presence of material misstatement, given the auditor-specified relationship. There is, therefore, a confounding of two key factors that cannot be ignored.

We recommend that risk considerations for analytical procedures be broadened in this ED to include the auditor's additional consideration of the risk the assumed relationship between data might be materially misleading. (See our comment regarding A5 below.)

Specific comments

Par. 4. *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. (Ref: par. A1–A5)*

The ED fails to define the term “significant” or how the magnitude of a significant deviation relates to two other terms that appear in the authoritative literature: material and tolerable. Such lack of specificity might create a lack of clarity, which could only lead to inconsistency in practice.

We recommend that wording similar to the following be added to the last sentence:

A significant deviation of an observed amount from its estimated amount is that magnitude of deviation for which the risk of material misstatement exceeds the risk that the auditor considered appropriate when planning the analytical procedure.

A1. *Analytical procedures include the consideration of comparisons of the entity's financial information with, for example,*

- *similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.*

This is a commonly cited example. It is, however, impracticable because contemporaneous data for comparable industry entities is rarely available.

A5. A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary.

This paragraph fails to recognize the inherent, unspecified risk that the relationships have changed and are no longer applicable (the absence of known conditions to the contrary notwithstanding). Deviation of observed data from the estimates does not provide a valid basis for assessing this risk.

We recommend that wording similar to the following be added to the last sentence:

The auditor should assess the risk that the specified relationships are not applicable and the effect of that risk on the conclusions to be drawn from consideration of deviations between estimated and observed values. To the extent that estimates are based on incorrect assumptions as to relationships, those estimates are biased and undermine effectiveness of analytical procedures.

A8. The auditor may inquire of management about the availability and reliability of information needed to apply substantive analytical procedures and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

Although par. A8 does not specifically refer to the audits of accounting estimates, this would be an appropriate place to include some additional explanatory language for the examination of estimates.

We recommend adding language, such as the following.

1) At the end of the first sentence, add:

[...procedures performed by the entity], **such as those used to prepare accounting estimates.**

2) At the end of the paragraph, add:

An auditor has two basic approaches in applying analytical procedures in the examination of accounting estimates: 1) perform a study of the client's methodology and data, including re-performing the client's analysis; and 2) employ an independently developed analysis that has the same measurement objective as the client's. In either approach, it is important for the auditor to evaluate the relationship[s] between the variables under consideration and to have obtained reasonable assurance regarding the data that are used to estimate the relationship[s] and to calculate the analytical procedures' estimated value of the accounting estimate that is under examination.

A10. The suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

We recommend that a cross-reference between A5 and A10 be included.

A14. Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

The guidance regarding testing subsequent cash receipts is generally impracticable and expensive, however definitive the procedure may be, because it may take many months to properly evaluate a sample of receivables. Although agings might themselves be suitable for tests of details, the most practicable approach to assessing the reasonableness of an entity's allowance for uncollectible receivables is an analytical procedure. Moreover, if applied, the results of subsequent cash should override any analytical procedure.

The example is a poor one. We recommend that it be removed.

A15. In addition, because expenditure on the acquisition of assets may not be capitalized, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements.

This example is incorrect and should be removed. All local governments that have capital assets are required to capitalize, in accordance with GASB 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*.

A16. The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

The consequence of using unreliable data to form relationships is not explicitly stated anywhere in the authoritative literature. We recommend that the following sentence be added at the end of this paragraph:

The use of unreliable data to form relationships is likely to result in incorrect expectations which increases the risk that the analytical procedure will fail to detect material misstatements

A19. The risk that material misstatement may be obscured by offsetting factors increases as an entity's operations become more complex and more diversified. Disaggregation helps reduce this risk.

The guidance, while appropriate, might mislead an auditor to placing greater reliance on an analytical procedure than is appropriate. We recommend that the following caveat be added:

Disaggregation, however, does not eliminate the inherent risk of an analytical procedure's failure to detect a material misstatement. A large deviation from an analytical procedure's expected value may correctly lead an auditor to conclude that a material misstatement exists. It is also true that the procedure may lead the auditor to conclude that a material misstatement does not exist because an observed deviation from expected value is small. This can happen because 1) the expected value is incorrect or 2) management had fraudulently created an offsetting value which masks the misstatement, even if the expected value is correct.

Other comment

A5, A8, A11, A16. The references to "Data" should be as a plural noun.