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Auditing Subsequent Events: Perspectives from the Field

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SUMMARY: A research synthesis team formed by the Auditing Section of the American Accounting Association recently authored a paper (Chung et al. 2013) addressing the audit of subsequent events (SEs). The audit of SEs is a difficult audit area, as approximately one-third of the Public Company Accounting Oversight Board's inspection reports and numerous Securities and Exchange Commission enforcement releases identify deficiencies in this area (Chung et al. 2013). Chung et al. (2013) developed a model and proposed a series of research questions encouraging future academic research in this area. In this paper, we address several of these questions by surveying 76 practicing auditors. We summarize the auditors' responses and present recommendations that may be useful in improving audits of SEs.

Keywords: subsequent events; client negotiations; time budgets; judgment process.

INTRODUCTION

A research synthesis team formed by the Auditing Section of the American Accounting Association recently published a paper (Chung et al. 2013) describing the audit processes related to subsequent events (SEs). The authors conclude that the audit of SEs is a difficult audit area and support this assertion with their finding that approximately one-third of the Public Company Accounting Oversight Board's (PCAOB) inspection reports and numerous Securities and Exchange Commission (SEC) enforcement releases identify deficiencies in this area. Chung et al. (2013) developed a model and proposed a series of unexamined research questions encouraging future academic research in this area. In this paper, we address several of these questions by surveying 76 practicing auditors at a large regional public accounting firm, asking open-ended questions about factors affecting audits of SEs and recommendations for improving SE procedures.

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Using scale survey items, Janvrin and Jeffrey (2007) surveyed auditors regarding their SE experiences and practices.[1] They found that although auditors generally conduct procedures designed to discover SEs, these procedures are frequently unsuccessful. The present study adds to the SE audit literature by taking a step toward investigating several additional research questions proposed by Chung et al. (2013) using an open-ended response approach and qualitative data analysis.

We summarize auditors' responses and, drawing from their responses, discuss recommendations that may be useful in improving audits of SEs. Specifically, we discuss SE audit program considerations, the SE period, engagement time budgets, and auditor-client relationships. However, our results and recommendations should be interpreted with caution as our study involves a relatively small number of auditors from one audit firm.

BACKGROUND

Professional standards require auditors to (1) search for SEs, (2) evaluate the impact of any SEs on the financial statements, and (3) ensure that SEs are resolved appropriately (AU Section 560, PCAOB 2003). The search includes procedures specifically intended to discover SEs such as reviewing the latest available board minutes and interim financial statements, making management inquiries, and obtaining written representations. Material Type I SEs (i.e., the underlying condition existed at balance sheet date) should be recognized in the financial statements, whereas material Type II SEs (i.e., the underlying condition did not exist at balance sheet date) should be disclosed (PCAOB 2003, AU Sections 560.03, 560.05).[2]

Unlike auditing a recorded balance such as an account receivable, or substantiating a known transaction such as the sale of property, the audit of SEs involves an open-ended search from the balance sheet date through the date of the audit report encompassing all significant accounts and transactions without knowing specifically what one is searching for (Chung et al. 2013). Supporting the notion that auditing SEs is inherently complex, Chung et al. (2013) examined PCAOB inspection reports and numerous SEC enforcement releases concluding that properly identifying, evaluating, and resolving SEs can be problematic for both management and auditors. Auditors struggle to audit SEs effectively due, in part, to the inherent complexity associated with searching through a seemingly boundless universe of potential SEs and the continuous nature of the SE search (Chung et al. 2013, 192).

Little academic research on SEs exists. Janvrin and Jeffrey (2007) examined how auditors search for and discover SEs and factors that influence this process. The authors surveyed 106

[1] Janvrin and Jeffrey (2007) examined auditors' perceptions of SE evidence importance, how SE evidence searches are implemented, how much time respondents spend searching for SEs, how frequently respondents perform recommended SE search procedures, and how effective the recommended procedures are in identifying SEs. Further, the authors explored the following factors that may influence SE audits: routine versus non-routine accounts, amount of evidence supporting balance sheet date judgment, consistency with prior expectations regarding balance sheet date judgment, consistency of anticipated challenge with prior evidence, materiality of anticipated challenge evidence, length of search period, and time pressure. Challenge evidence refers to any additional evidence items, including SE evidence, that may cause auditors to reconsider their current judgment. Likert-type scale survey items were used by the authors so that statistical analyses could be performed.

[2] Under U.S. Generally Accepted Accounting Principles (GAAP), the Financial Accounting Standards Board's Accounting Standards Codification (ASC) refers to Type I SEs as ''recognized'' subsequent events and refers to Type II SEs as ''nonrecognized'' subsequent events (ASC 855-10-20, FASB 2010).

TABLE 1
Participant Demographics

		Years in Public Accounting	
Level	**n**	**Mean**	**Median**
Staff	17	2.0	2.0
Senior	20	6.2	5.0
Manager	8	8.6	7.5
Senior manager	6	19.1	15.0
Partner	25	20.9	20.0
Total	76	11.4	7.5

auditors at large public accounting firms and found that auditors deem SE evidence to be important. The authors conclude that auditors generally follow suggested procedures (e.g., review of interim financial statements) to search for SEs, but are more likely to find SE evidence when minimal historical evidence exists and their balance sheet date judgments do not meet prior expectations. Further, Janvrin and Jeffrey (2007) find that auditors are more likely to search for SE evidence (1) when evaluating nonroutine accounts, (2) when evaluating evidence that may impact the financial statements as a whole rather than one account, and (3) when they have ample time to conduct the search. Finally, they report that auditors are more likely to find SE evidence when the search period (from balance sheet date to report date) is longer.

Chung et al. (2013) discuss the audit processes related to SEs and issues that have arisen related to these processes in practice. In particular, they draw from relevant academic research to develop a theoretical model and present a series of unexamined research questions to facilitate future academic research on this topic. The authors reviewed a number of PCAOB inspection reports and SEC enforcement releases that identified deficiencies in the audit of SEs. Some deficiencies were noted in the substantive testing phase of the audit, while others pertained to the active SE search phase. Some deficiencies related to issues in the search for SEs, while others related to problems with auditors' evaluation of SEs (i.e., the auditors were aware of the SE but did not understand the implications of the SE for their audit work or their assessment of fair presentation). Based on their research, Chung et al. (2013) proposed 34 research questions (some of which they suggest could be addressed using a survey methodology) to guide future research into the causes of SE audit deficiencies and the development of strategies to improve SE audit effectiveness.

METHOD

To investigate why SE audit deficiencies may occur and what might be done to improve things, we surveyed practicing auditors. Seventy-six auditors at a large regional public accounting firm participated in this research. The participating firm is one of the 25 largest firms in the U.S. (SourceMedia 2012). Recruitment emails were sent by an audit partner to all 445 auditors at the firm. Second-request emails were sent after one week. The response rate was 17.1 percent. The recruitment email included a link to an Internet-based survey site that hosted the anonymous survey. Participant demographics are presented in Table 1.

TABLE 2

Briefly Describe How Your Firm Audits Subsequent Events

Client inquiry	56
Review of subsequent interim financial statements	38
Updating attorney letters	33
Review of subsequent board minutes	30
Review of subsequent journal entries	19
Review of subsequent cash payments/receipts	19
Obtaining management representations	3
Website review/news articles	3
Other	1

We asked open-ended survey questions to address a subset of research questions adapted from the recommendations of Chung et al. (2013). We reconcile our survey questions to several of Chung et al.'s (2013) formally proposed research questions (RQ) in the next section. To analyze the responses, we used content analysis to code the data following procedures recommended by Creswell (2003). Using open coding (Strauss and Corbin 1998), data were coded into major categories by each author independently. The authors then resolved discrepancies by indepth discussion and negotiated consensus.

RESULTS

For contextual purposes, we obtained and reviewed the participating firm's SE audit program.[3] We also asked participants to describe how their firm audits SEs. Table 2 presents a summary of responses to this question. Client inquiry was the most-cited SE procedure. One partner summarized the firm's SE audit procedures as follows:

> We have an internally developed checklist to ask questions. We also review subsequent board minutes and talk to the client or board regarding minutes that have not been completed, especially if we are aware of a possible issue. We also update the legal letters through the date of issuance of the report or within three days prior to issuance.

Another partner responded as follows:

> Inquiry, [obtaining] representations from management and internal/external counsel, review of board minutes, subsequent financial statement review and inquiry of those outside of CFO/Controller (but done inconsistently within the firm), review of subsequent activity in key areas primarily of judgment (but also done very inconsistently in the firm).

[3] The program contained four parts. The first part listed detailed audit procedures that the auditor is to perform, such as reviewing journal entries from the financial statement date through the end of fieldwork, noting that, depending on the results of this review, the auditor is to consider the need to expand testing through the report date. Another procedure is to read subsequent meeting minutes or to inquire as to actions taken at subsequent meetings that may impact the financial statements. The second part involved the review of interim financial statements, and the third part involved inquiries of management. The third part included specific questions to ask of management. For example, "Were there any changes to the current status of items in the financial statements being reported on that were accounted for on the basis of tentative, preliminary, or inconclusive data?" The final part of the program related to updating attorney letters.

TABLE 3

What Factors May Affect Your Search for and Evaluation of Subsequent Events?

Knowledge of client and client activities	15
Risk	12
How smoothly the substantive testing phase of the audit went	8
Materiality	8
Management integrity	7
Length of time period between balance sheet date and report date	7
Client size/complexity	4
Industry	4
Relationship/interaction with client	3
Time constraints/deadlines	2
Availability of subsequent financial statements and board minutes	2
Other	2

Three other auditors also noted inquiry of client personnel outside of financial management as an SE audit procedure, even though mention of such an "outside" corroborative inquiry is absent from the firm's SE program.

Search for and Evaluation of Subsequent Events

Auditors must search for information about material SEs and gather sufficient evidence about the SEs in order to appropriately evaluate them. Chung et al. (2013) propose that auditors' searches for and evaluation of SEs may be impacted by various factors including certain judgment and decision-making heuristics and biases such as availability and representativeness heuristics (RQ9), overconfidence bias (RQ10), client preference bias (RQ11), accountability and justification requirements (RQ12), framing effects (RQ13), confirmation bias (RQ14), primacy effect (RQ15), and time pressure (RQ16). Chung et al.'s (2013) RQ18 asks what additional factors affect auditors' searches for and evaluation of SEs. In an effort to gain more insight into this matter, we asked participants to discuss any factors that may affect their search for and evaluation of subsequent events. Table 3 summarizes auditors' responses to this question.

Familiarity with the client and client activities is the most-cited factor that would affect an auditor's search for and evaluation of SEs, followed by client risk assessments. As one partner explained:

> The industry the client is in, history and knowledge of the client and the industry, materiality, and also risk assessments for the client.

Another partner stated:

> Known litigation or potential litigation, possible malpractice lawsuits and their status (I work in the healthcare area), known settlements from Medicare or Medicaid after year-end. Client interactions—[for] some clients I will expand this search due to past history. With others, there is little risk—[it] depends on who is relying on the financial statements.

A different partner responded as follows:

TABLE 4

If You Were Reviewing Audit Documentation and Realized More Evidence Is Needed to Evaluate a Subsequent Event, What Would You Do?

Obtain more evidence	51
Client inquiry (a specific form of obtaining more evidence)	22
Appropriate procedures/whatever is necessary	6
Discuss with partner	5
Expand the search for subsequent events	3
Other	1

> Items of high degree of judgment in the year-end financial statements at year-end or subsequent adverse operating results along with known contingencies where we know there may be ongoing activity regarding development of the situation.

Chung et al.'s (2013, 170) model of the auditor's cognitive approach to the audit of SEs suggests that auditors may demonstrate a feedback loop whereby their *evaluation* of an SE may cause them to expand the *search* for SEs. They depict this loop in their model as Link 9, which reconnects the evaluation phase back to the search phase via a dotted line. The authors also question whether time pressure might cause auditors to skip this step (RQ17). To examine these proposals, we asked auditors the following questions: "If you were reviewing audit documentation and realized more evidence is needed to evaluate a subsequent event, what would you do?" and; "How likely would time pressure (e.g., audit engagement hours are over budget or a deadline is fast approaching) affect your answer to the above question?" Table 4 reports a summary of auditor responses to the question on what to do if more SE evidence is needed after evaluation.

In addition to the obvious responses of obtaining the necessary additional evidence, three auditors mentioned that they would expand the search for SEs, providing some support for Link 9 in Chung et al.'s (2013, 170) model and the link in Janvrin and Jeffrey's (2007, 299) SE model, which also depicts the evaluation phase reconnecting back to the search phase via a dotted line. For the question on whether time pressure would affect auditors' actions, we had participants respond on a scale of 1 (very unlikely) to 7 (very likely). Both the mean and median response was 3 (i.e., somewhat unlikely) suggesting that, on average, if additional evidence were needed, time pressure would not affect auditors' pursuit of the necessary evidence. However, three auditors (a partner, a senior, and a staff auditor) selected 7, suggesting that time pressure may influence this feedback loop step for some auditors. Indeed, an audit senior responded as follows:

> Depends on what my workload is like and whether I have time for it.

Resolution of Subsequent Events

After evaluating SE audit evidence, auditors must decide on how the event should be resolved (i.e., recognized, disclosed, or ignored). Resolution is often negotiated with clients, and these negotiations must be handled delicately (Chung et al. 2013). Auditors are challenged by the often-competing priorities of ensuring that the financial statements are materially accurate while maintaining a good relationship with the client (Perreault and Kida 2011).

Chung et al. (2013) propose that the audit of SEs may be influenced by the nature of the process whereby lower-level auditors search for SEs and higher-level auditors evaluate and

TABLE 5

What Factors May Influence an Auditor's Negotiation and Resolution of Subsequent Events with Clients?

Materiality and impact on financial statements	20
Potential effect on the users of the financial statements	10
Relationship and history with the client	7
Timing issues	7
None—GAAP only	5
Auditor judgment on likelihood	4
Client knowledge level	3
Pressure from client	3
Availability of information from an independent source	3
Other	5

negotiate/resolve them (RQ19). They also propose that time pressure (RQ20 and RQ21), negotiation timing (RQ22), accountability and justification requirements (RQ23), commitment escalation (RQ24), and client risk (RQ25) may impact the resolution of SEs. Chung et al.'s (2013) RQ26 asks what other factors can influence the negotiation and resolution of SEs. Accordingly, we asked participants to discuss any factors that may influence their negotiation and resolution of subsequent events with clients. Table 5 summarizes their responses.

Materiality considerations and the SE's potential effect on financial statement users are the most-cited factors. Related relevant excerpts from participant responses follow (all partners):

> Past experience with client, materiality (both quantitatively and qualitatively), the amount of judgment required to evaluate the subsequent event.
>
> Financial condition of the client, significance, and materiality of the item.
>
> Materiality, past history with the client, qualitative significance of the event.

Seven auditors mentioned timing considerations as a factor that may affect SE negotiation with a client. For example, two partners responded with the following:

> Identification of the event late during the audit engagement.
>
> Timing is almost always an issue.

A manager cited the following related factors:

> Deadlines, pressure from the client.

A staff auditor responded as follows:

> Pressure from the client, especially if they are a large client that partners are trying to please; time constraints.

Another manager responded as follows:

> Timeliness of [client/attorney] responses, amount of detailed information the client can provide, client awareness of disclosure requirements for subsequent events.

TABLE 6

What Are Some Factors That Could Make It Difficult for Auditors to Successfully Identify and Evaluate Subsequent Events?

Uncooperative client (withholds information)	19
Client not identifying subsequent events	11
Poor communication by client management	8
Client fraud	8
Timing/deadline	7
Vague or missing board minutes	6
No subsequent interim financial statements available	5
Lack of ability to independently verify items	5
Auditor not asking the right question	3
Other	3

Interestingly, five auditors were adamant that no factors would influence their negotiating a SE with a client. Relevant responses follow.

A manager responded:

> No negotiation—GAAP will always be applied.

Two different partners responded:

> If it's a material subsequent event, there is no negotiation.

> Typically, the standards and firm policies are clear as to what should/should not be disclosed. Deviance from that isn't tolerated.

Deficiencies in Subsequent Events Auditing

Chung et al. (2013) examined PCAOB inspection reports and SEC enforcement releases and, in light of the numerous audit deficiencies identified in the SE area, concluded that identifying and resolving SEs is difficult for auditors. Chung et al. (2013) asked why auditors have so much difficulty in appropriately identifying (RQ1) and appropriately evaluating (RQ3) SEs. To address this issue, we asked participants to discuss any factors that could make it difficult for auditors to successfully identify and evaluate subsequent events. Table 6 reports a summary of auditor responses.

The top four reasons cited all focus on the important role of the client: client uncooperativeness, the clients' failure to identify SEs, poor communication from the client, and client fraud. Excerpts from three partners provide relevant examples of this position:

> If [a] deadline is near, clients can be very uncooperative in disclosing subsequent events.

> Integrity of management. If they [the client] wanted to not tell me something, it would be difficult for me to discover it.

> Lack of cooperation and communication from management and/or owners of the client.

TABLE 7

Please Discuss Any Tools, Such as Decision Aids, That You Use in the Audit of Subsequent Events

Firm checklist/program	27
Professional guidance	7
None	5
Materiality, as well as qualitative effect	2
Other	3

Other response themes include timing issues and missing documentation. Four respondents placed at least some of blame for SE difficulties on auditors. A staff auditor responded as follows:

> Lack of time and training in identifying and questioning the client on such events.

Improving Subsequent Events Auditing

Prior research indicates that the use of decision aids can improve auditor judgment and help less-experienced auditors (Bonner, Libby, and Tan 1996; Lowe and Reckers 2000; Bedard and Graham 2002; Rose, McKay, and Norman 2012). Although the use of decision aids in the SE audit context has not yet been explored, Chung et al. (2013) suggest that using decision aids could potentially mitigate SE judgment biases. Chung and colleagues' RQ7 inquires as to how firms are currently utilizing decision aids in the audit of SEs (if at all). We asked participants to discuss any tools, such as decision aids, that they use in the audit of SEs. Table 7 presents a summary of responses to this question. Twenty-seven auditors mentioned the firm's standard SE checklist as a decision aid. Beyond this, little else is mentioned.

Several research questions proposed by Chung et al. (2013) include queries regarding what can be done to improve the auditing of subsequent events (e.g., RQ1, RQ3, RQ5, RQ7, RQ30, and RQ34). Consequently, we asked auditors to discuss what can be done to improve the auditing of subsequent events. Table 8 presents a summary of participant answers.

Although the leading response theme is "not much," auditor responses in the other categories do in fact suggest a number of possibilities. Relevant excerpts pertaining to the "not much" category from two partners follow:

TABLE 8

What Can Be Done to Improve the Auditing of Subsequent Events?

Not much (too dependent on client)	6
Client training	5
Better communication with the client	4
Make it more a part of regular audit procedures	4
Inquire of more client personnel (outside of accounting)	3
Timely issuance of audit reports subsequent to fieldwork	2
Criminal/civil penalties for clients that withhold information	2
Ensuring that auditors complete the SE audit program	2
Devoting more time to the audit of SEs	2
Other	6

> Not much—it is truly dependent upon the client disclosing to the audit team and willing to disclose in the financials.
>
> The auditing hasn't really been the problem. The disclosures present more of the problem . . . the client doesn't want to give an outside party too much information, which can be seen by some as an admission that certain liabilities are owed.

As noted, other respondents offer several suggestions. Response themes in these categories include improving communication with clients, client training, integrating SE procedures into "core" fieldwork procedures, and allocating more of the engagement budget to auditing SEs.

A manager suggested the following:

> Make it more a part of the regular audit procedures; sometimes it feels like an afterthought and we sometimes rush through the program so that we can get the report issued.

A staff auditor echoed these sentiments:

> Taking more time to complete the task. I find that it is a really quick process at the very end to get the financials out the door.

Another staff auditor provided the following response:

> Try not to add it in the "wrap-up" phase. Once we see the end of the tunnel, I think we can have a tendency to throw it all together quickly. If we add notes to our subsequent events documentation about things we come across during standard audit procedures, which could possibly have a related subsequent event [implication], we have some specific items to address.

A senior manager suggested the following:

> Communication with management throughout the audit process; listen to what the client's employees may tell you about what is happening; keep an open mind about the possibility of a subsequent event; keep your ears open when working in the client's office; know your client—be aware of what is happening in their industry, and what the client's needs are for the future.

DISCUSSION

We surveyed 76 practicing auditors at a large regional public accounting firm asking open-ended questions about factors affecting audits of SEs and recommendations for improving SE procedures. Using Likert-type scale survey items, Janvrin and Jeffrey (2007) find that although auditors generally follow recommended SE audit procedures, the procedures are frequently unsuccessful. This study adds to the SE audit literature by analyzing auditors' open-ended responses to questions on factors that may influence SE searches, evaluation, negotiation and resolution, sources of SE audit difficulties, and ways to improve the auditing of SEs. We contribute to the SE audit literature by providing a glimpse into the actions and reactions of some individuals involved in the audit of SEs and delve deeper into the connections between the various (or lack of) SE procedures.

Drawing from the auditors' responses, we now present some recommendations that may be useful in improving audits of SEs. Specifically, we discuss audit program considerations (client inquiry, SE procedures, client knowledge, and decision aids), the SE period, engagement time budgets, and auditor-client relationships. Our recommendations should be interpreted with caution, however, as our study involves a relatively small number of auditors from one audit firm. In some cases, recommendations are based on the suggestions of very few participants. We elaborate on this point when discussing the limitations of our study below.

Audit Program Considerations

Client Inquiry

A few auditors noted inquiry of client personnel outside of financial management as an SE audit procedure, even though mention of such an "outside" corroborative inquiry is absent from the participating firm's SE audit program. One partner even noted that this procedure was performed inconsistently within the firm. The notion of interviewing individuals other than the controller or CFO, such as individuals in operations, certainly has merit. If not already included in their SE audit programs, then firms might consider adding explicit language to their internal SE checklists instructing auditors to also question client personnel outside of financial management on SE matters.

Integrating SE Procedures into the Substantive Testing Phase

Several respondents suggested that SE procedures be made more a part of regular audit procedures, as opposed to being tacked on to the wrap-up phase of the audit. This idea also has some appeal. Auditors should be considering SE implications throughout their fieldwork. To encourage this consideration, audit firms may wish to add specific steps to the audit programs for each account group (if not already included in such programs). For example, the following might be added to the accounts receivable audit program: "In performing the audit steps above, describe any transactions or events you noted that may have subsequent events implications." Some firms have advanced audit program software whereby auditor responses to certain program steps automatically flow through to other summary memos and programs (Carson and Dowling 2012). Such a summary program could be developed for SEs. Thus, the summary SE program could include relevant auditor notes on SEs made during the substantive testing phase, in addition to the wrap-up steps described in the standard SE audit program.

Knowledge of the Client

Auditor knowledge of the client and client activities was the leading response theme for the question on what factors influence auditors' searches for and evaluation of SEs. Clearly, familiarity with the client is an important determinant of a successful SE audit. Indeed, the level of auditors' client-specific knowledge has been found to be positively related to auditor performance over time (Knechel, Krishnan, Pevzner, Shefchik, and Velury 2013). Auditors can gain client-specific knowledge by serving the same client year after year (Chi, Huang, Liao, and Xie 2009). However, this is not always possible due to scheduling conflicts, auditor turnover, or audit partner rotation. Audit firms might consider other ways to enhance auditors' familiarity with client activities, such as devoting time in the planning phase of the audit to obtain background information and knowledge of the client's business and including some type of "understanding the client" memo in the planning section of the audit file (Blokdijk, Drieenhuizen, Simunic, and Stein 2006).

Decision Aids

Chung et al. (2013) indicate that decision aids could mitigate SE judgment biases and may help less-experienced auditors. They note that the use of decision aids in the SE audit context has not yet been explored. Outside of the participating firm's SE checklist, respondents did not reference any other decision aid used to assist them in the audit of SEs. We conducted some Internet searches (focused on sites such as the American Institute of Certified Public Accountants and various educational accounting and CPA firm websites) and reviewed some auditing textbooks and found very little guidance in terms of SE decision aids for auditors. Consequently, we drafted our own flowchart that may be used as a decision aid to assist auditors in SE procedures. Figure 1 is intended to assist auditors in the identification and evaluation of SEs. This decision aid relates only to SEs regarding contingent liabilities. There are other types of SEs that would not be covered by this decision aid.[4] Firms may consider adding something similar to their SE audit programs or training materials in order to help their auditors (especially juniors) in this difficult audit area.

Figure 1 begins by encouraging auditors to consider SEs throughout the substantive testing phase of the audit as opposed to only considering SEs during the wrap-up phase. Next, five specific SE procedures are presented for the auditor to follow in an effort to identify material SEs that relate to losses (realized or contingent). If a material SE with loss implications is identified, then auditors must determine: (1) if the condition existed at the balance sheet date, (2) whether loss likelihood is probable, possible, or remote and, if applicable, (3) whether a reasonable loss estimate can be made. The flowchart ends with the SE resolutions.

Subsequent Events Period

The "subsequent period" is the period after the balance sheet date through the audit report date. Janvrin and Jeffrey (2007) find that auditors are more likely to find SE evidence when the search period (from balance sheet date to report date) is longer. If the SE period is longer, then there is more time for some event or transaction with SE implications to occur, and there is more time for the auditor to discover it. Although a longer period may be helpful in clarifying a situation that existed at the balance sheet date, a drawn out SE period may prove problematic for auditors. Auditors may wish to limit their exposure to a long SE period to mitigate the risk that they might miss something. Indeed, two respondents mention the timely issuance of the audit report as a way to improve the auditing of SEs. One partner noted:

> Timely issuance of audit reports subsequent to fieldwork.

A senior responded as follows:

> Get audits done sooner so there isn't as great of a span for events to happen.

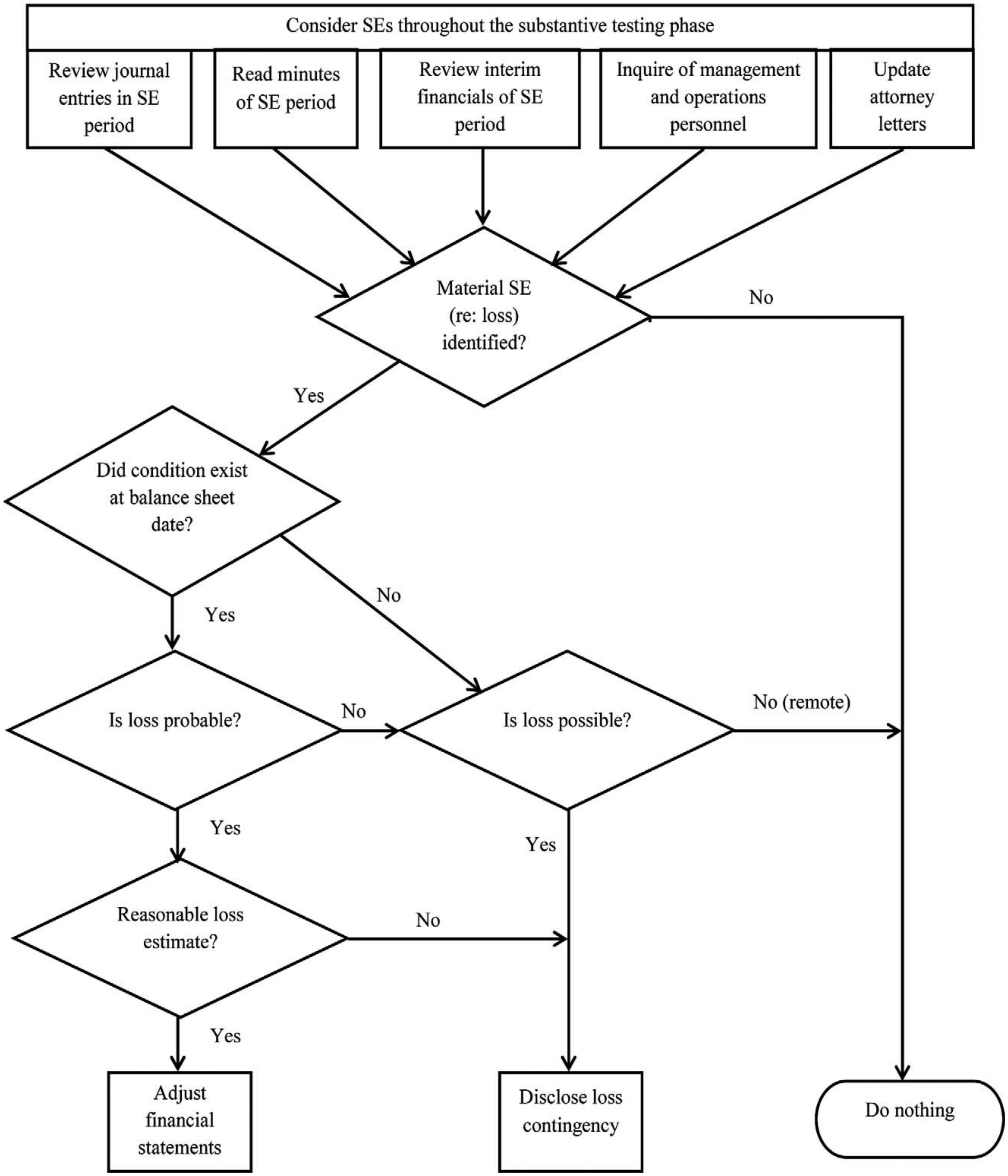
The sentiments of these auditors are understandable and firms should do what they can to promote the timely issuance of financial statements and limit the length of the SE search period. However, we do recognize that this suggestion has more to do with auditors covering their bases and less to do with actually improving audits of SEs.

Engagement Time Budget

Some respondents indicated that more time should be allocated to auditing SEs. Although most audit budgets are usually pretty tight, firms might consider adding a slight "cushion" to various higher-risk audit areas during the substantive testing phase to allow auditors to reflect on

[4] For example, other SEs could relate to asset impairments, inventory valuation issues, deferred tax asset valuation allowances, and revenue recognition issues (see Chung et al. 2013, Table 1).

FIGURE 1
Decision Aid for Auditing Subsequent Events Regarding Contingent Liabilities



SE implications. Additionally, firms may wish to consider devoting a little more time to SEs in the wrap-up phase. Similar to fraud brainstorming discussions that engagement teams typically hold at the beginning of an audit, firms might consider having teams hold a live discussion on SEs in the wrap-up phase of the audit.

Auditor-Client Relationships

Several auditors noted that the nature of their relationship and interactions with the client might influence the effectiveness of their search for and evaluation of SEs, as well as their negotiation/resolution of SEs with the client. High-quality auditor-client relationships are important. Prior research suggests that relationship issues are a primary determinant of clients switching audit firms (Fontaine, Letaifa, and Herda 2013). Research also indicates that high-quality auditor-client relationships lead to more value-added service provided to the client (Herda and Lavelle 2013).[5] The present study suggests that strong auditor-client relationships may assist auditors in identifying and evaluating SEs, and may also be helpful in negotiating SE adjustments and/or disclosures with clients. Chung et al. (2013, 188) note that in light of the little existing authoritative guidance with respect to SEs, auditors may be particularly susceptible to the influence of client preferences when negotiating the resolution of an SE. This highlights the importance of mutual trust and strong relationships between auditors and clients. A trusting relationship will likely reduce the risk that clients will withhold information with SE implications from auditors. Rather, the client would trust the auditor with the information knowing that the auditor would act in the best long-term interests of the client, while complying with relevant professional standards. Trusting relationships come about through fair treatment and mutual commitment (de Ruyter and Wetzels 1999; Herda and Lavelle 2013).

Limitations

Our study has limitations. We caution that the comments from our 76 participants at one audit firm might not be representative of a larger auditor population. Therefore, our results and corresponding recommendations may not generalize to auditors at other, larger firms. Future research could involve more auditors and auditors with larger accounting firms that serve a significant number of publicly traded companies. Also, this study only begins to address the many research questions proposed by Chung and colleagues (2013). Future research could address more of the questions using alternative methodologies, such as face-to-face interviews or experiments.

Implications

Being mindful of this study's limitations, we now summarize the practical implications of our research. Auditors should consider SE implications throughout the substantive testing phase of the audit and may wish to also question client personnel outside of financial management as part of their normal SE audit procedures. Audit firm management should work to ensure that all audit team members have an appropriate level of client and industry knowledge, as this may impact their ability to identify and evaluate SEs. Audit firms may wish to add a decision aid (similar to Figure 1) to their SE audit programs or training materials to assist auditors in this area. Firms may wish to

[5] Value-added audit service is defined as client-service activities resulting from an audit that are not directly related to verifying the financial statements (Herda and Lavelle 2013).

limit the length of the SE period by promoting the timely issuance of financial statements. Audit firms may consider adding a "cushion" to time budgets for various high-risk areas to allow auditors to reflect on SE implications during the substantive testing phase, and also devote more time to SE matters in the wrap-up phase, perhaps even holding live engagement team discussions on SEs toward the end of the audit. Finally, firms should emphasize the importance of building and maintaining strong relationships with clients through fair treatment and mutual commitment (de Ruyter and Wetzels 1999; Herda and Lavelle 2013). Strong auditor-client relationships characterized by mutual trust may assist auditors in identifying and evaluating SEs, and may also be helpful in identifying and negotiating SE issues with clients.

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