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Public Company Accounting Oversight Board

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STANDING ADVISORY GROUP MEETING

AUDITING FINANCIAL STATEMENT DISCLOSURES

MARCH 24, 2011

Introduction

The Public Company Accounting Oversight Board ("PCAOB" or the "Board") is evaluating whether, in light of recent events and changes to accounting standards, the auditor's responsibilities for auditing financial statement disclosures should be updated or enhanced, including whether revisions to PCAOB auditing standards or additional guidance is needed.

This briefing paper provides background information on the requirements in PCAOB auditing standards that are relevant to auditing financial statement disclosures, the relevant recent events and changes to accounting standards, and certain challenges associated with auditing financial statement disclosures. The staff is seeking the SAG's feedback in determining the need for additional guidance or revisions to PCAOB auditing standards.

Background

The federal securities laws are designed to protect investors through full and fair disclosure of material information. Towards that end, issuers must file audited financial statements each year in their annual reports, and companies seeking to become issuers must include audited financial statements in their registration statements. Material misstatements or omissions in financial statements can give rise to liability under the federal securities laws' antifraud provisions. Rule 4-01(a) of Regulation S-X, which sets out general requirements for financial statements filed with the Securities and Exchange Commission, further reflects this policy of full and fair disclosure:

> Financial statements should be filed in such form and order, and should use such generally accepted terminology, as will best indicate their significance and character in the light of the provisions applicable thereto. The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.[1/]

Under PCAOB standards, auditors are required to plan and perform the audit to obtain reasonable assurance about whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. This includes performing procedures to test the financial statement disclosures and to evaluate whether those financial statements contain the disclosures required by the financial reporting framework and the information essential for fair presentation of the financial statements. The next section of this briefing paper discusses these required procedures in more detail, and the appendix to this briefing paper presents examples of requirements in PCAOB standards regarding auditing financial statement disclosures.

Requirements in PCAOB Auditing Standards

PCAOB auditing standards recognize the importance of financial statement disclosures by directing auditor attention to them throughout the audit process. For example, PCAOB standards require the auditor to develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.[2/] PCAOB standards also require auditors to perform procedures to assess the risk of omitted, incomplete, or inaccurate disclosures, whether intentional or unintentional;[3/] to identify

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1/ 17 CFR § 210.4-01(a).

2/ Paragraph 12 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. Auditing standards Nos. 8-15 were adopted by the Board on August 5, 2010. See PCAOB Release No. 2010-004, *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* available at: http://pcaobus.org/Rules/Rulemaking/Docket%20026/Release_2010-004_Risk_Assessment.pdf.

3/ See, for example, paragraphs 49, 52, and 67 of Auditing Standard No. 12.

and test significant disclosures;[4/] and, in integrated audits, to test controls over significant disclosures.[5/]

When evaluating whether the financial statements are fairly presented in conformity with the applicable financial reporting framework, the auditor also is required to evaluate the disclosures, which includes, among other things:

- Evaluating whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation,[6/] and

- Considering the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.[7/]

Evaluation of disclosures also involves evaluation of the effect on the financial statements of uncorrected misstatements in disclosures, such as omitted, incomplete, or inaccurate disclosures. Although evaluation of uncorrected misstatements requires consideration of relevant qualitative and quantitative factors,[8/] qualitative considerations

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4/ See, for example, paragraphs 59-64 of Auditing Standard No. 12 and paragraph 9 and footnote 6 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*. A disclosure is a significant disclosure if there is a reasonable possibility that the disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements.

5/ Paragraph 26 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

6/ Paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.* References to AU sections ("AU sec.") throughout this paper are to the PCAOB's interim auditing standards, which consist of generally accepted auditing standards, as described in the American Institute of Certified Public Accountants ("AICPA") Auditing Standards Board's Statement of Auditing Standards No. 95, as in existence on April 16, 2003, to the extent not superseded or amended by the Board. These standards are available on the PCAOB's web site at: http://pcaobus.org/Standards/Auditing/Pages/default.aspx.

7/ Paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.*

8/ Paragraph 17 of Auditing Standard No. 14.

are especially important to the evaluation of misstatements in disclosures. PCAOB auditing standards describe the auditor's responsibilities for considering qualitative factors in the context of the auditor's consideration of materiality.[9/]

In addition to the aforementioned general responsibilities for auditing disclosures, PCAOB auditing standards impose specific requirements for certain types of disclosures. The following are examples of PCAOB auditing standards that have requirements regarding auditing disclosures:

- Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*
- AU sec. 328, *Auditing Fair Value Measurements and Disclosures*
- AU sec. 334, *Related Parties*
- AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
- AU sec. 560, *Subsequent Events*
- AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*[10/]

Trends and Recent Developments in Financial Statement Disclosures

Financial statement disclosures have evolved significantly in their extent and nature. Decades ago, accounting standards and SEC rules required financial statements to include certain basic disclosures. The increasing complexity of business transactions, including off-balance sheet transactions and non-recognition of assets and liabilities;[11/] the increased use of fair value and other accounting estimates, with

[9/] See, for example, paragraph 24 and Appendix A of Auditing Standard No. 14.

[10/] The Board has separate projects related to the five interim standards (AU sections) in this list. Those projects include evaluation of the specific requirements for auditing the disclosures associated with those areas.

[11/] For example, under Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Income Taxes Topic, section 740-30-50, all of the following information shall be disclosed whenever a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes related to subsidiaries and corporate joint ventures:

significant uncertainties and changes in measurement attributes;[12/] and demands from financial statement users for more relevant information have resulted in an increase in disclosures that are more extensive[13/] and that contain more qualitative information.

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a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable.

b. The cumulative amount of each type of temporary difference.

c. The amount of the unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable. While paragraph 740-30-25-14: prohibits recognition of a tax benefit for tax deductions or favorable tax rates attributable to future dividends of undistributed earnings for which a deferred tax liability has not been recognized, favorable tax treatment would be reflected in measuring that unrecognized deferred tax liability for disclosure purposes.

d. The amount of the deferred tax liability for temporary differences other than those in (c) (that is, undistributed domestic earnings) that is not recognized in accordance with the provisions of paragraph 740-30-25-18.

12/ For example, under ASC Topic 825-10-50, the following disclosures, among others. are required for financial instruments:

a. Either in the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value

b. The method(s) and significant assumptions used to estimate the fair value of financial instruments

c. A description of the changes in the method(s) and significant assumptions used to estimate the fair value of financial instruments, if any, during the period.

13/ The FASB has undertaken a disclosure framework project, and describes the objectives of this project as follows:

Also, some disclosures, such as those relating to the fair values of certain assets and liabilities, include, or are based on, information about events or conditions that are not captured by processing and recording systems for routine transactions. Examples of such other information include market pricing data and information about events or conditions that are external to the company.

Recently issued or proposed accounting standards updates ("ASUs") require additional disclosures that are considered more qualitative in nature. Those ASUs also reflect an increased emphasis on disclosures that achieve specified objectives, for which financial statement preparers are required to use their judgment to determine the nature and extent of information that should be disclosed to meet the objectives stated in the standards. Certain examples include:

- FASB Proposed ASU, *Revenue from Contracts with Customers* ("Revenue ASU"). The Revenue ASU provides for increased judgment in determining the appropriate level of disclosures by stating that an "entity shall consider the level of detail necessary to satisfy the disclosure requirements and how much emphasis to place on each of the various requirements."[14/] "…[i]f it has not met the disclosure objective then the entity shall disclose whatever additional information is necessary to meet that objective."[15/]

The objectives of this project are to (1) establish an overarching framework intended to make financial statement disclosures more effective and coordinated and (2) seek ways to better integrate information provided in financial statements, Management Discussion & Analysis (MD&A), and other parts of a reporting entity's financial reporting package. The project objective is not intended to be additive but, rather, to develop a framework for improved U.S. Generally Accepted Accounting Principles (GAAP) that promotes meaningful communication and logical presentation of disclosures and avoids unnecessary repetition.

(Source: FASB project summary (updated as of February 11, 2011), at its web site, available at: http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1176156344894#fi_derecognition.)

[14/] Revenue ASU, paragraph 70.

[15/] Revenue ASU, paragraph 71.

- FASB Proposed ASU, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* ("Financial Instruments ASU"). The Financial Instruments ASU requires that the entity "determine, in light of facts and circumstances, how much detail it is required to provide to satisfy the disclosure requirements, and how it disaggregates information into classes for assets with different risk characteristics," and indicates that an entity "should strike a balance between obscuring important information as a result of too much aggregation and overburdening financial statements with excessive detail that may not assist financial statement users in understanding the entity's financial instruments and allowance for credit losses. For example, an entity should not obscure important information by including it with a large amount of insignificant detail. Similarly, an entity should not disclose information that is so aggregated that it obscures important differences between the different types of financial instruments and associated risks."[16/]

Auditing Considerations Regarding Recent Developments in Financial Statement Disclosures

The objective-based nature of certain disclosure requirements, the complexity of the matters disclosed, and the qualitative nature of certain disclosures can pose additional risks of material misstatement. Also, disclosures that are more qualitative, subjective, or complex often require different types of controls than those used for processing and reporting on routine historical transactions. For the former types of controls, the necessary controls are more likely to be manual controls rather than automated controls and may require significant judgment in the operation of the control, which, in turn, can affect the risk associated with the control.

From an auditing perspective, effective evaluation of disclosures that are more qualitative, subjective, or complex typically needs to be performed by experienced auditors who understand the company, its industry, and the relevant disclosure requirements. Also, to effectively evaluate those disclosures, auditors need to exercise professional skepticism and be alert for events or conditions that may contradict management's assertions in the disclosures.

Obtaining audit evidence that is relevant for evaluating some disclosures might require different auditing procedures from those used to evaluate disclosures of routine

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[16/] Financial Instruments ASU, paragraph IG 171. Additional disclosure guidance is included in paragraph IG 169 and IG 170.

historical data. For example, the evidence needed to evaluate a particular disclosure might come from sources outside the company's accounting system or possibly from sources outside the company.

Discussion Questions

1. What are the challenges in auditing financial statement disclosures? Have recent changes to the accounting standards resulted in auditing challenges?

2. Are changes to auditing standards needed regarding auditing financial statement disclosures?

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The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.

Appendix
Examples of Requirements in PCAOB Auditing Standards Regarding Auditing Financial Statement Disclosures[1]

I. General Requirements for Auditing Disclosures

Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*

Paragraph 7

[Regarding establishing a materiality level for particular accounts or disclosures.]

The auditor should evaluate whether, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. If so, the auditor should establish separate materiality levels for those accounts or disclosures to plan the nature, timing, and extent of audit procedures for those accounts or disclosures.

Lesser amounts of misstatements could influence the judgment of a reasonable investor because of qualitative factors, e.g., because of the sensitivity of circumstances surrounding misstatements, such as conflicts of interest in related party transactions.

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[1] The examples in this appendix illustrate how PCAOB standards direct auditor attention to disclosures throughout the audit process. Because this briefing paper discusses the auditor's responsibilities regarding auditing financial statement disclosures, the examples in this appendix relate only to auditing financial statement disclosures. Other PCAOB standards that relate to disclosures outside of the financial statements include AU sec. 550, *Other Information in Documents Containing Audited Financial Statements,* and AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents.* Also, this briefing paper does not address auditor's responsibilities described in AU sec. 558, *Required Supplementary Information,* regarding unaudited information disclosed in the financial statements.

Paragraph 8

[Regarding determining tolerable misstatement for testing accounts and disclosures.]

The auditor should determine the amount or amounts of tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level. The auditor should determine tolerable misstatement at an amount or amounts that reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the financial statements. Accordingly, tolerable misstatement should be less than the materiality level for the financial statements as a whole and, if applicable, the materiality level or levels for particular accounts or disclosures.

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*

Paragraphs 4-5

[Regarding the overarching requirement for performing risk assessment procedures, sources of risks of material misstatement, and the top-down approach to risk assessment.]

The auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud, and designing further audit procedures.

Risks of material misstatement can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting. For example, external or company-specific factors can affect the judgments involved in determining accounting estimates or create pressures to manipulate the financial statements to achieve certain financial targets. Also, risks of material misstatement may relate to, e.g., personnel who lack the necessary financial reporting competencies, information systems that fail to accurately capture business transactions, or financial reporting processes that are not adequately aligned with the requirements in the applicable financial reporting framework. Thus, the audit procedures that are necessary to identify and appropriately assess the risks of material misstatement include consideration of both external factors and company-specific factors.

This standard describes an approach to identifying and assessing risks of material misstatement that begins at the financial statement level and with the auditor's overall understanding of the company and its environment and works down to the significant accounts and disclosures and their relevant assertions.

Paragraphs 12-13

[Regarding understanding the company's selection and application of accounting principles, including disclosures.]

As part of obtaining an understanding of the company's selection and application of accounting principles, including related disclosures, the auditor should evaluate whether the company's selection and application of accounting principles are appropriate for its business and consistent with the applicable financial reporting framework and accounting principles used in the relevant industry. Also, to identify and assess risks of material misstatement related to omitted, incomplete, or inaccurate disclosures, the auditor should develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.

The following matters, if present, are relevant to the necessary understanding of the company's selection and application of accounting principles, including related disclosures:

- Significant changes in the company's accounting principles, financial reporting policies, or disclosures and the reasons for such changes;

- The financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles;

- The accounts or disclosures for which judgment is used in the application of significant accounting principles, especially in determining management's estimates and assumptions;

- The effect of significant accounting principles in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;

- The methods the company uses to account for significant and unusual transactions; and

- Financial reporting standards and laws and regulations that are new to the company, including when and how the company will adopt such requirements.

Paragraphs 28, 29, and 32

[Regarding obtaining an understanding of the information system relevant to financial reporting as part of understanding the company's internal control.]

The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including … e. The period-end financial reporting process.

The auditor also should obtain an understanding of how IT affects the company's flow of transactions.

The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the approach used to identify significant accounts and disclosures and their relevant assertions and, when applicable, to select the controls to test, as well as to assess risk and allocate audit effort.

A company's period-end financial reporting process, as referred to in paragraph 28.e., includes the following … Procedures for preparing annual financial statements and related disclosures (and quarterly financial statements, if applicable).

Paragraph 49

[Regarding the discussion among key engagement team members of the risks of material misstatement.]

The key engagement team members should discuss (1) the company's selection and application of accounting principles, including related disclosure requirements, and (2) the susceptibility of the company's financial statements to material misstatement due to error or fraud.

The key engagement team members should discuss the potential for material misstatement due to fraud either as part of the discussion regarding risks of material misstatement or in a separate discussion.

As discussed in paragraph 67, the financial statements might be susceptible to misstatement through omission of required disclosures or presentation of inaccurate or incomplete disclosures.

Paragraph 52

[Regarding the discussion among key engagement team members about fraud risks.]

The discussion among the key engagement team members about the potential for material misstatement due to fraud should occur with an attitude that includes a questioning mind, and the key engagement team members should set aside any prior beliefs they might have that management is honest and has integrity. The discussion among the key engagement team members should include … An exchange of ideas, or "brainstorming," among the key engagement team members, including the engagement partner, about how and where they believe the company's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the company could be misappropriated, including (a) the susceptibility of the financial statements to material misstatement through related party transactions and (b) how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures;

Paragraphs 59-64

[Regarding the process of assessing the risks of material misstatement and identifying relevant assertions of significant accounts and disclosures.]

The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. In identifying and assessing risks of material misstatement, the auditor should … e. Identify significant accounts and disclosures and their relevant assertions…

The determination of whether an account or disclosure is significant or whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

To identify significant accounts and disclosures and their relevant assertions in accordance with paragraph 59.e., the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include:

- Size and composition of the account;

- Susceptibility to misstatement due to error or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- Nature of the account or disclosure;
- Accounting and reporting complexities associated with the account or disclosure;
- Exposure to losses in the account;
- Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- Existence of related party transactions in the account; and
- Changes from the prior period in account and disclosure characteristics.

As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.

The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the audit of internal control over financial reporting as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same for both audits.

In the financial statement audit, the auditor might perform substantive auditing procedures on financial statement accounts, disclosures, and assertions that are not determined to be significant accounts and disclosures and relevant assertions.

The components of a potential significant account or disclosure might be subject to significantly differing risks.

When a company has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the consolidated financial statements.

Paragraph 67

[Regarding assessing fraud risks.]

Consideration of the Risk of Omitted, Incomplete, or Inaccurate Disclosures. The auditor's evaluation of fraud risk factors … should include evaluation of how fraud could be perpetrated or concealed by presenting incomplete or inaccurate disclosures or by omitting disclosures that are necessary for the financial statements to be presented fairly in conformity with the applicable financial reporting framework.

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*

Paragraph 5

[Regarding overall responses to fraud risks.]

The auditor should design and implement overall responses to address the assessed risks of material misstatement as follows:

c. *Incorporating elements of unpredictability in the selection of audit procedures to be performed.* As part of the auditor's response to the assessed risks of material misstatement, including the assessed risks of material misstatement due to fraud ("fraud risks"), the auditor should incorporate an element of unpredictability in the selection of auditing procedures to be performed from year to year. Examples of ways to incorporate an element of unpredictability include:

   (1) Performing audit procedures related to accounts, disclosures, and assertions that would not otherwise be tested based on their amount or the auditor's assessment of risk…

Paragraph 8

[Regarding performing audit procedures in response to risks of material misstatement.]

The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.

Paragraph 36

[Regarding performing substantive audit procedures.]

The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.

Auditing Standard No. 14, *Evaluating Audit Results*

Paragraph 4

[Regarding the process of evaluating audit results.]

In the audit of financial statements, the auditor's evaluation of audit results should include evaluation of the following … e. The presentation of the financial statements, including the disclosures

Paragraph 5

[Regarding performing an overall review as part of evaluating audit results.]

In the overall review, the auditor should read the financial statements and disclosures and perform analytical procedures to (a) evaluate the auditor's conclusions formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement.

Paragraph 12

[Regarding accumulating misstatements for evaluation.]

The auditor's accumulation of misstatements should include the auditor's best estimate of the total misstatement in the accounts and disclosures that he or she has tested, not just the amount of misstatements specifically identified. This includes misstatements related to accounting estimates, as determined in accordance with paragraph 13 of this standard, and projected misstatements from substantive procedures that involve audit sampling, as determined in accordance with AU sec. 350, *Audit Sampling.*

Paragraph 17

[Regarding the evaluation of uncorrected misstatements.]

The auditor should evaluate whether uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the specific accounts and disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.

In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him …."

As a result of the interaction of quantitative and qualitative considerations in materiality judgments, uncorrected misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue. Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

If the reevaluation of the established materiality level or levels, as set forth in Auditing Standard No. 11, results in a lower amount for the materiality level or levels, the auditor should take into account that lower materiality level or levels in the evaluation of uncorrected misstatements.

Paragraph 24

[Regarding the evaluation of potential management bias in the financial statements.]

When evaluating whether the financial statements as a whole are free of material misstatement, the auditor should evaluate the qualitative aspects of the company's accounting practices, including potential bias in management's judgments about the amounts and disclosures in the financial statements.

Paragraph 26

[Regarding the evaluation of the effect of identified management bias on the financial statements.]

If the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, the auditor should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. Also, the auditor should evaluate whether the auditor's risk assessments, including, in particular, the assessment of fraud risks, and the related audit responses remain appropriate.

Paragraph 31

[Regarding the evaluation of the adequacy of disclosures as part of evaluating whether the financial statements are presented fairly.]

As part of the evaluation of the presentation of the financial statements, the auditor should evaluate whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework. Evaluation of the information disclosed in the financial statements includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.

According to AU sec. 508, if the financial statements, including the accompanying notes, fail to disclose information that is required by the applicable financial reporting framework, the auditor should express a qualified or adverse opinion and should provide the information in the report, if practicable, unless its omission from the report is recognized as appropriate by a specific auditing standard.

Paragraph A2

[Definition of the term "misstatement."]

Misstatement – A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework. A misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework. Misstatements can arise from error (i.e., unintentional misstatement) or fraud.

AU sec. 508, *Reports on Audited Financial Statements*

Paragraph .41

[Regarding modifying the auditor's report because of inadequate disclosure.]

Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include the related notes). When such information is set forth elsewhere in a report to shareholders, or in a prospectus, proxy statement, or other similar report, it should be referred to in the financial statements. If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express a qualified or adverse opinion because of the departure from those principles and should provide the information in the report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific Statement on Auditing Standards.

AS No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*

Paragraphs 22, 24, and 26

[Regarding evaluating the controls related to the period-end financial reporting process as part of evaluating entity-level controls.]

The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting. The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

Entity-level controls include … [c]ontrols over the period-end financial reporting process

Period-end Financial Reporting Process. Because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements, the auditor must evaluate the period-end financial reporting process. The period-end financial reporting process includes the following… Procedures for preparing annual and quarterly financial statements and related disclosures

Paragraph 39

[Regarding testing controls over relevant assertions, which relate to significant accounts and disclosures.]

The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.

II. Requirements for Auditing Specific Disclosures

The following are examples of PCAOB auditing standards that have requirements regarding auditing specific disclosures:

- Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*
- AU sec. 328, *Auditing Fair Value Measurements and Disclosures*
- AU sec. 334, *Related Parties*
- AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
- AU sec. 560, *Subsequent Events*
- AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*