

February 26, 2010

Mr. Keith Wilson, Associate Chief Auditor
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

By e-mail: comments@pcaobus.org

**Re: PCAOB Release No. 2009-007 – Proposed Auditing Standards Related to the Auditor’s Assessment of and Response to Risk and Related Amendments to PCAOB Standards
(PCAOB Rulemaking Docket Matter No. 026)**

Dear Mr. Wilson:

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 release.

The NYSSCPA’s SEC Practice Committee and Auditing Standards Committee deliberated the release and prepared the attached comments. If you would like additional discussion with us, please contact Anthony S. Chan, Chair of the SEC Practice Committee at (212) 331-7653, 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

**PCAOB RELEASE NO. 2009-007 – PROPOSED AUDITING STANDARDS
RELATED TO THE AUDITOR’S ASSESSMENT OF AND RESPONSE TO RISK
AND RELATED AMENDMENTS TO PCAOB STANDARDS**

(PCAOB RULEMAKING DOCKET MATTER No. 026)

February 26, 2010

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Comments on

PCAOB Release No. 2009-007

Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards

(PCAOB Rulemaking Docket Matter No. 026)

We welcome the opportunity to respond to the Public Company Accounting Oversight Board's ("PCAOB") *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (the "New Proposed Standards"). On balance, we believe that the New Proposed Standards are well written, and we do not anticipate any significant implementation issues as they are properly aligned with PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

We begin our response with comments on convergence. The balance of the letter is organized in the following order, presenting specific comments on each proposal followed by answers to the questions posed in Appendix 9, *Additional Discussion*.

- A. Audit Risk
- B. Audit Planning and Supervision
- C. Consideration of Materiality in Planning and Performing an Audit
- D. Identifying and Assessing Risks of Material Misstatement
- E. The Auditor's Responses to the Risks of Material Misstatement
- F. Evaluating Audit Results
- G. Audit Evidence

Convergence of Auditing Standards

We support the Board's consideration of the work of other standard setters. We recognize that the Board may decide that different procedures are appropriate in the U.S. public company audit context, and, therefore, we encourage the Board to continue to minimize the differences in its standards to only those matters that are particular to audits of issuers in the U.S. Such a practice would result in highlighting the different procedures required in the U.S. public company audit context and improve the understanding of the PCAOB standards.

Minimizing differences allows firms, for example, to cultivate synergies related to training, implementation, and the development and maintenance of quality control systems that accommodate the standards of the various standard-setting bodies (all factors that we believe efficiently contribute to enhanced audit quality).

Additional Discussion of Topics

Question 1. Are the objectives in the new proposed standards useful in providing context for the requirements in the standards?

Yes.

A. Audit Risk

Specific Comment:

Paragraph, 7b defines control risk as "... the risk that a misstatement due to error or fraud that could occur in an assertion and that could be material, individually or in combination with other misstatements, will not be prevented or detected on a timely basis by the company's internal control." To align this closer to the International Auditing and Assurance Standards Board (IAASB) and Auditing Standards Board (ASB) definition and to clarify that controls are designed to result in correction of detected misstatements, we suggest the insertion of the word "corrected" in the sentence—"...will not be prevented, or detected and corrected, on a timely basis..."

Questions:

2. Does the new proposed standard on audit risk describe clearly the concept of audit risk and its components?

Yes.

3. Does the new proposed standard on audit risk describe clearly the relationship between detection risk and substantive procedures?

Yes. We agree that it does.

B. Audit Planning and Supervision

Specific Comments:

1. Paragraph 3 describes the responsibility of the engagement partner for planning and supervision of the audit. However, the description does not consider the circumstance, which may be common in multi-location audits when there is more than one engagement partner and, as such, we recommend clarifying the responsibility of the engagement partners in such a circumstance.
2. Paragraphs 11 and 12 (multi-location engagements) refer to "consolidated" financial statements in a manner that is inconsistent with the terminology as used elsewhere in the standards. Although these paragraphs deal with multiple locations, they may be business divisions that do not meet the definition of "consolidation." We suggest the removal of the word "consolidated."
3. Paragraph 14 refers to paragraph 5 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, and provides a summary of the guidance relating to audits of multi-location entities. However, the summary only includes one aspect of introducing unpredictability in auditing procedures, and does not seem to be specific to a multi-location engagement. The paragraph states that the "auditor should vary the nature, timing, and extent of audit procedures at locations or business units from year to year" whereas we believe it would be more appropriate within the context of multi-location engagements to discuss the concept of unpredictability in terms of varying the location where audit procedures are to be performed.

- 4.. Paragraph 15 describes the circumstances when the auditor should modify the overall strategy and audit plan and includes matters such as a revised assessment of the risk of material misstatement or the discovery of a previously unidentified risk of material misstatement. We recommend including the concept of “changes to planning materiality” as another example of such a circumstance.
5. Paragraph A2 defines the term “engagement partner” as a member of the engagement team with primary responsibility for the audit. We recommend having this definition conform to Auditing Standard No. 7, *Engagement Quality Review*, which defines the term as “The member of the engagement team with primary and final responsibility for the audit.”

Questions:

4. Are the proposed requirements for multi-location engagements appropriately aligned with Auditing Standard No. 5?

We believe the proposed requirements are appropriately aligned with Auditing Standard No. 5, except for the item noted below, relating to paragraph 14.

5. Is it clear how the proposed requirements for multi-location engagements would be applied in audits of financial statements only?

Yes, the proposed requirements clearly describe how the multi-location guidance would be applied in audits of financial statements only.

6. Are the differences between the responsibilities for supervision of engagement team members and oversight of specialists in accordance with AU sec. 336 appropriate in light of the auditor’s responsibilities to opine with reasonable assurance on whether the financial statements are fairly presented, in all material respects, in conformity with the applicable financial reporting framework?

Yes, the differences between the responsibilities for supervision of engagement team members and oversight of specialists is appropriate. We believe that the engagement partner should be responsible for the supervision of all engagement team members, including those with specialized skill and knowledge, whether engaged or employed by the auditor, and recognize that in carrying out this responsibility with respect to the oversight of specialists, specific oversight procedures are necessary. As such, we support the Board’s standard setting project to review AU sec. 336, *Using the Work of a Specialist*, to address the auditor’s use of specialists.

C. Consideration of Materiality in Planning and Performing an Audit

Specific Comments:

1. Paragraph 2, quotes *TSC Industries v. Northway, Inc.*, saying 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.” ... See also *Basic, Inc. v. Levinson*

TSC Industries Inc. v. Northway Inc. is a case which concerned the omission of certain facts from a proxy statement. The quote used in the proposal is incomplete, and as such we believe is taken out of context since it does not address omitted facts. The full quote follows:

“...a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact

would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”

With respect to *Basic, Inc. v. Levinson*, the court “adopted, for the §10(b) and Rule 10b-5 context, the standard of materiality set forth in *TSC Industries, Inc. v. Northway, Inc.*”

We believe the definition of materiality with reference to the U.S. Supreme Court is inappropriate as it might impact auditor liability and increase litigation risk. Because the definition does not appear dissimilar from that of SAB 99, *Materiality*, (in which the SEC described the qualitative aspect of materiality as that of any matter important to the reasonable reader of financial statements), we question why reference to the Supreme Court case is necessary and suggest removal of this reference. If the Board does not follow this suggestion, we recommend that the complete quote from TSC be used in the final standard.

2. Paragraph 6. When planning the audit, the auditor should establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This includes consideration of the company’s earnings and other relevant factors. To determine the nature, timing, and extent of audit procedures, the materiality level for the financial statements as a whole needs to be expressed as a specified amount. So that auditors do not focus on the use of “earnings” as the materiality measuring stick, we recommend that “other relevant factors” be expanded to give examples of other factors that may require consideration. Such other relevant factors include (a) net revenues, (b) financial position totals (c) account balances, and (d) the trend from year to year of these benchmarks. Additionally, we believe the Standard should also discuss the consistency of the benchmark used to determine materiality from year to year and the documentation for the reasons for any changes in the benchmark.
3. Paragraph 8. Accordingly, the amount or amounts of 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. This last sentence appears to be a third level of materiality; we therefore recommend that this paragraph clearly indicate the materiality thresholds auditors should consider.
4. Paragraph 9. In determining tolerable misstatement and planning and performing audit procedures, the auditor should take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods. We recommend that the Standard clarify this paragraph by saying “...and amount of both corrected and uncorrected misstatements...”
5. Paragraph 11(b). The financial statements used in establishing the materiality level or levels and in determining tolerable misstatement have changed significantly, e.g., because significant adjustments to the financial statements would result in a lower amount for the materiality level or levels or tolerable misstatement. This situation is addressed in the proposal Evaluating Audit Results (paragraph 16) which says:

Note: If the reassessment of materiality as set forth in paragraphs 11-12 of Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*, results in a lower amount for the materiality level, the auditor should take into account that lower materiality level in the evaluation of uncorrected misstatements.

We therefore propose providing a cross reference from paragraph 11(b) to this paragraph.

General Comments:

We believe that this auditing standard is not sufficiently robust (lacking implementation guidance) to guide auditors in establishing levels of procedures which will provide sufficient appropriate evidence to support audit opinions. One of our primary concerns we have is that the standard ignores the distinction between accounting materiality and audit materiality, by not discussing these terms (and their use) separately. Audit materiality (also known as performance materiality and planning materiality) is the maximum value of any undetected misstatement given the maximum acceptable risk (the maximum risk the auditor is willing to accept). For example, if overall audit risk expressed in a percentage is 10% and materiality is \$100,000, audit scope would be designed to yield no more than a 10% risk of detecting misstatement in excess of \$100,000.

Audit materiality is used in three ways: (1) as a scope determinant for sampling applications, (2) as a limit on untested population (if untested population is larger than materiality it could contain material misstatement), and (3) as the judgmentally determined amount over which an analytical procedure designed to be used as a primary substantive test would identify misstatement. Paragraphs 7 and 8 imply that tolerable error determination should be less than materiality as discussed in paragraph 6. We agree that the (accounting) materiality should be a sensitized user/investor driven value and consequently a small value relative to any entity's financial statements. A relatively small number as a starting point for the determination of tolerable error is unworkable. Sampling procedures use tolerable error as a determinant of sampling precision. Tolerable error should be an amount which is three to four times larger than accounting materiality to be able to include sampling precision (the difference between upper error limit and projected error). Projected error on sampling tables extrapolate quickly so that upper error limits are at least three times projected error in most circumstances.

We believe a consideration of sampling precision both in the planning phase and the evaluation phase (for substantive testing procedures) is necessary. Audit risks, entity size considerations, and user considerations can be built into benchmarking concepts that underpin sampling methodologies, with user considerations emphasized, for audit planning materiality determinations. Once the desired sampling precision (both overall and at the assertion/test levels) is determined, then the audit tests can be appropriately evaluated and measured for effectiveness. The proposed standard fails to deal with these elemental concepts.

To quote Leslie, Teitelbaum, and Anderson (1979). *Dollar Unit Sampling – A Practical Guide for Auditors*, (1979), "...a materiality limit for an individual audit engagement has two uses: as a guide to audit planning (design and extent of verification procedures) and as a guide to evaluation of audit results (the formation of an audit opinion)." This is particularly important in the use of sampling." ***And sampling is at the heart of what auditors do*** (our emphasis).

Questions:

7. Are the provisions in the new proposed standard regarding consideration of materiality in multi-location engagements appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination, would result in material misstatement of the financial statements?

Yes, we believe the proposed revisions are appropriate.

8. Are the revised provisions regarding reassessment of materiality appropriate in light of the auditor's responsibility to plan and perform audit procedures to detect misstatements that,

individually or in combination, would result in material misstatement of the financial statements?

Yes, we believe the proposed revisions are appropriate. However, some of the language in paragraph 11 is possibly too restrictive. For example, the auditor is required to “reassess the established materiality level or levels and tolerable misstatement,” but the reason listed implies that only materiality by definition (i.e., that which would influence reasonable investors) would need to change. The reason listed is “because of changes in the particular circumstances or additional information that comes to the auditor's attention, there is a substantial likelihood that misstatements of amounts that differ significantly from the materiality level or levels that were established initially would influence the judgment of a reasonable investor.” We believe this reason should be expanded or made less restrictive. Presumably tolerable misstatement could change without materiality changing the auditor’s risk assessment as a particular area changes.

D. Identifying and Assessing Risks of Material Misstatement

Specific Comments:

1. Paragraph 4. “The auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of the risks of material misstatement due to error or fraud (footnote omitted) and to design further audit procedures. 4/”
We suggest adding to this sentence the underlined “...and to design further audit procedures focused on the areas of greatest risk.”
2. The phrase “design further audit procedures” is used in paragraphs 18 and 33. Those paragraphs should reference back to footnote 4.
3. Note [one] in paragraph 10 says: “The size and complexity of a company might affect the risks of misstatement and how the company addresses those risks.” However, this note does not provide any additional guidance about auditing in the smaller company environment. Additionally, the Note to paragraph 17 also does not provide any additional insights into the procedures to perform in the smaller company environment. This paragraph states, “Smaller companies might have less formal processes to measure and review financial performance. In such cases, the auditor might identify relevant performance measures by considering the information that the company uses to manage the business.” We recommend revising these notes to provide specific guidance in the application of:
Note [two] to paragraph 10: “The auditor should take into account the information gathered while obtaining an understanding of the nature of the company when determining the existence of related parties, in accordance with AU sec. 334, Related Parties.” We suggest revising this note as follows “The auditor should take into account the information gathered while obtaining an understanding of the nature of the company to determine when ~~determining~~ the existence of related parties....”
4. Paragraph 12, third bullet says “The accounts or disclosures in which judgment is used in the application of significant accounting principles, especially in determining management’s estimates and assumptions.” We recommend adding a step to say that auditors compare prior years estimates and assumptions to this year’s actual results (for example, the estimated

allowance for inventory obsolescence compared to amounts actually sold below cost, scrapped, etc.) to determine the risks related to such estimates and assumptions.

This point may also be related to paragraph 15, fifth bullet: “Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated.)”

5. Paragraph 36 should be clarified by removing the first sentence:
6. The preceding paragraphs discuss the auditor’s responsibilities for obtaining an understanding of internal control as part of performing risk assessment procedures. The objective of obtaining an understanding of internal control, (as discussed in paragraph 18), is different from testing controls for the purpose of assessing control risk 17/ or for the purpose of expressing an opinion on internal control over financial reporting in the audit of internal control over financial reporting.
7. We recommend expanding the Note to paragraph 45 as follows: “Analytical procedures performed as risk assessment procedures often use data that is preliminary or data that is aggregated at a high level and ordinarily are not designed with the level of precision necessary for substantive analytical procedures.”
8. We believe that footnote 22 (to paragraph 46) is important enough to be included in the body of the standard. This example should then be referenced to paragraph 68.
9. Paragraph 56(d): “Assess the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements.” We believe the term “likelihood” should be defined in terms of reasonable possibility as that term is used in AS 5 paragraphs 63-65.

Questions:

9. Does the new proposed standard adequately describe the auditor’s responsibilities for performing risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of risks of material misstatement due to error or fraud and to design further audit procedures?

Yes, we believe the responsibilities are adequately described.

10. Are the auditor’s responsibilities regarding the additional procedures for understanding the company and its environment in paragraph 11 clear?

Yes.

11. Are the proposed requirements regarding obtaining an understanding of internal control over financial reporting appropriate in light of the auditor’s responsibilities for identifying and assessing the risks of material misstatement?

Yes, we believe the proposed requirements are appropriate.

12. Are the proposed requirements regarding the discussion among engagement team members about risks of material misstatement appropriate given the auditor’s responsibilities for identifying and assessing the risks of material misstatement?

Yes.

E. The Auditor’s Responses to the Risks of Material Misstatement

Specific comments:

1. There is some inconsistent terminology. For example, paragraph 41 states, “The auditor's substantive procedures must include the following...”, while “should” is used elsewhere to indicate requirements.
2. The document is silent on the response to identified information technology general control (“ITGC”) risks. IT risk assessment is discussed in Appendix B - Consideration of Manual and Automated Systems and Controls of Appendix 4 (pageA-4, paragraph 32). However, consideration of how IT processing may introduce specific risks relating to fraud or error occurring in the financial statements and the response to such risks should be mentioned in Appendix 5. For example, IT processing may introduce threats to data integrity, threats from hackers to system security, inappropriate access to restricted or sensitive data or ability to adjust records or post fraudulent entries and theft of financial and sensitive information.
3. Appendix 5 is silent on using the work of experts (specialists) as it relates to responding to identified risks. Appendix 7 on Audit Evidence discusses AU 336, but it might be helpful to also discuss it in Appendix 5 and refer to Appendix 7 for more detail.
4. There is very little reference to Entity-level controls ([it’s only mentioned one time) and possible reliance when the entity-level controls operate at a level of precision to achieve control objectives at the assertion level, which is especially meaningful for smaller companies who face segregation of duties issues and such entity-level monitoring controls are the only compensating controls that may exist.
5. Paragraph 5(b). The reference to Audit Planning and Supervision should be included in a footnote.
6. Paragraph 5(c). Examples of ways to incorporate an element of unpredictability are (a) 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; ... (c) selecting items for testing that have lower amounts or are otherwise outside customary selection parameters....
The Board should clarify the difference between (c) “... outside selection parameters..., and (a)...”would not otherwise be tested....”
7. Paragraph 6. Examples of such pervasive changes include performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence. We recommend eliminating the examples and reference paragraphs 39-46 of the Proposal in a footnote.

8. Paragraph 22. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation and re-performance of the control. The Board should also consider further expanding this listing of procedures to include computer assisted audit techniques ("CAATs").
9. Paragraph 23. Note: To obtain evidence about whether a control must be tested directly.... The Board should consider clarifying this. We believe that the audit team can continue to rely on internal audit and the work of others for the testing of certain controls if the auditor can determine that the work of others is performed by competent and objective personnel.
10. Paragraph 24. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control.

Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.

In addition to inquiry, we believe that observation alone does not support a conclusion about the effectiveness of a control. Inquiry and observation can be performed in tandem to possibly support the conclusion depending on the nature of the control being tested; i.e., to verify that policies and procedures have been established, an auditor can inquire of appropriate management personnel and observe a copy of the relevant policies and procedures manual.
11. Paragraph 27, fourth bullet: "The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control."

Paragraph 39, "Substantive procedures generally provide persuasive evidence when they are designed and performed to obtain evidence that is relevant and reliable."

Paragraph 39, Note: Proposed Auditing Standard, Audit Evidence, provides more direction regarding the types of substantive procedures and the relevance and reliability of audit evidence.

Paragraph 42. "However, increasing the extent of an audit procedure cannot adequately address an assessed risk of material misstatement unless the evidence to be obtained from the procedure is reliable and relevant."

The term "appropriateness" (or "appropriate") should be used in place of relevance and reliability in the above quotes to conform to its use in paragraphs 7 and 17 in the proposal, and its definition in the Audit Evidence proposal at paragraph 6 which says, "Appropriateness is the measure of the quality of audit evidence, i.e., its relevance and reliability."
12. Paragraph 30 states: The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors:

An added bullet is required, which states:

The client company should maintain documentation of all changes in internal controls introduced during the period under audit. That documentation should be available to the auditor.
13. Paragraph 44. In determining whether it is appropriate to perform substantive procedures at an interim date, the auditor should take into account the following:

The first item, a, should have an additional point: (3) A review of the internal control changes that have been made to date and the nature and extent of monitoring such changes by the client's staff.

Also consider adding a bullet point to include when the controls are designed or operating effectively.

Questions:

13. Are the proposed requirements for overall responses and responses involving the nature, timing, and extent of audit procedures appropriate given the auditor's responsibility to opine with reasonable assurance about whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?

Yes.

14. Does the new proposed standard clearly describe when tests of controls are necessary in an audit of financial statements only?

Yes.

F. Evaluating Audit Results

Specific comments:

1. Paragraph 4(e): The presentation of the financial statements, including disclosures; We suggest the following revision, "The presentation of the financial statements, including disclosures and omitted disclosures," or alternatively "including the required disclosures." This revision would then conform to paragraph 31 which says "...the auditor should evaluate whether the financial statements contain the required disclosures."
2. Paragraph 5. In the overall review, the auditor should read the financial statements and disclosures and perform analytical procedures to (a) assess 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. The auditor's standard report does not mention "financial statements as a whole" and paragraph 17 discusses the need to evaluate uncorrected misstatements in relation to the accounts and disclosures and to the financial statements as a whole (giving consideration to quantitative and qualitative factors). Further, paragraph 34(a) observes that the "significance of uncorrected misstatements and likelihood of their having a material effect, individually or in combination on the financial statements" does not discuss "financial statements as a whole." For those reasons we believe that Par. 5(b) should read "assist in forming an opinion on whether the financial statements as a whole are free of material misstatement."
3. Paragraph 13. If the auditor concludes that the amount of an accounting estimate included in the financial statements is unreasonable or was not determined in conformity with the applicable accounting principles.... We suggest that "applicable accounting principles" be differentiated from "applicable financial reporting framework" used elsewhere in the proposals, or change the former to the latter.
4. Paragraph 18. The auditor's evaluation of uncorrected misstatements, as described in the preceding paragraph, should include evaluation of the effects of uncorrected misstatements

detected in prior years and misstatements detected in the current year that relate to prior years.

For greater clarity, we recommend that this standard use the terms “rollover” and “iron curtain” as those terms are used in Staff Accounting Bulletin 108 (Topic 1, Section N of the SABs).

5. Paragraph 34(e). The relevance and reliability of the audit evidence obtained.
The proposal on Audit Evidence, at paragraph 6, says “Appropriateness is the measure of the quality of audit evidence, i.e., its relevance and reliability. To be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor’s opinion is based.” We therefore suggest that subparagraph (e) be revised to read “The appropriateness (i.e., the relevance and reliability) of the audit evidence obtained.”
6. Paragraph 35. ... If the auditor is unable to obtain sufficient appropriate audit evidence to have a reasonable basis to conclude about whether the financial statements as a whole are free of material misstatement
See the discussion under Item 2 regarding paragraph 5.
7. Appendix B2. (a). The potential effect of the misstatement on trends, especially trends in profitability.
“Profitability” is not a defined term. We suggest this sentence be clarified and changed to read:
The potential effect of the misstatement on trends, especially trends in profitability, for example, (a) gross profit, earnings before taxes, earnings after taxes, and (b) profitability as measured against other companies in the same or a similar industry.

Questions:

15. Does the new proposed standard clearly describe the auditor’s responsibilities for accumulating and evaluating misstatements?

We believe that the proposed standard clearly describes the auditor’s responsibilities for accumulating and evaluating misstatements. However we believe the standard could be improved with additional guidance on corrected audit adjustments. The proposed standard appropriately considers (in paragraph 34) that significant uncorrected misstatements need to be considered in reaching a conclusion that sufficient appropriate evidence has been obtained to support the auditor’s opinion.

We believe that significant corrected adjustments also should be considered in reaching this conclusion. For example, if a high level of audit adjustments were identified during the audit, this is a factor that should be considered in determining the level of audit evidence required. A material corrected misstatement, or several material corrected misstatements, could indicate that the auditor’s understanding of the client and its control environment, obtained during the planning phase of the engagement, may be incorrect and that the scope of the audit procedures should be reassessed. We therefore suggest that the factors in paragraph 34 be expanded to include some discussion about the effect of corrected misstatements on whether sufficient appropriate audit evidence has been obtained by the auditor.

16. Does the new proposed standard appropriately describe the auditor’s responsibilities for evaluating the presentation of the financial statements, including evaluating bias, in light of the

auditor’s responsibility to opine with reasonable assurance on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework?

We believe the proposed standard appropriately describes the auditor’s responsibilities for evaluating the presentation of the financial statements, including evaluating bias, in all material respects, in conformity with the applicable financial reporting framework.

G. Audit Evidence

Specific comments:

1. Paragraph 2. Audit evidence is all the information, whether obtained from audit procedures or other sources that is used by the auditor in arriving at the conclusions on which the audit opinion is based. Audit evidence consists of both information that supports and corroborates management’s assertions regarding the financial statements or internal control over financial reporting and any information that contradicts such assertions. It is unclear whether the last phrase, “and any information that contradicts such assertion,” means the auditor should look for such contradictory information, or applies only if such information comes to the attention of the auditor. If auditors should proactively look for such evidence, then the standard should provide guidance as to the procedures that should be followed to discover this conflicting evidence. Further, we recommend that this discussion be referenced to paragraph 29.

2. Paragraph 7a. The relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The relevance of audit evidence depends on:
 - a. The design of the audit procedure used to test the assertion or control, in particular whether it is designed to (1) test the assertion or control directly, and (2) test for understatement or overstatement.

We recommend the proposed standard should be revised to reflect a more expanded description of what relevance is. The redrafted AICPA audit standard on audit evidence provides the following in its paragraph A28-

“Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, when appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing. For example...”

3. Paragraph 8. The third bullet in paragraph 8 states, “Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly.” Because the proposed standard does not explain the term “indirectly,” the committee believes the proposed standard should provide examples of the types of evidence that are obtained directly and the types of evidence that are obtained indirectly. The fourth bullet in paragraph 8 states, “Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized, or otherwise converted into electronic form, *the reliability of which depends on the controls over the conversion and maintenance of those documents*”. [Emphasis added.]

If the purpose of the last sentence in this paragraph is to suggest that effective internal control could cause evidence from non-original documents to be considered reliable, then, in the Committee’s opinion, the first sentence in that paragraph, which states that evidence from non-original documents, is not as reliable as evidence from original documents appears to contradict

this position. We, however, believe that if there are proper controls over the conversion process, there should be no difference in the perceived reliability between original documents and converted documents. As technology progresses, more and more documentation will take electronic form. Paper documentation will increasingly become an archaic practice of the past. “Original documents” might, in fact, be electronic from the start, and never be “converted.” In this instance, it is not clear from the standard how reliable this evidence would be. Furthermore, because auditors were never document experts to begin with, the audit profession’s historical practice of attributing unquestioned reliability to physical documentation was never justified. We believe that electronic information, subject to the proper controls, is in many ways more reliable than physical documentation. We believe the standard should be revised to acknowledge this reality.

4. Paragraph 12. The auditor may base his or her work on assertions that differ from those in this standard if the assertions are sufficient for the auditor to identify the types of potential misstatements and to respond appropriately to the risks of material misstatement in each significant account and disclosure that have a reasonable possibility (footnote omitted) of containing misstatements that would cause the financial statements to be materially misstated.

We recognize this exact same language is in par. 28 of AS 5; however, the meaning of this paragraph is unclear. What assertions are not encompassed by the five assertions in the proposal? We believe additional guidance or examples are needed to explain the significance of this paragraph.

5. Paragraph 15. Paragraph 15 states - Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.

We believe that it is not enough for such controls to be effective, but that they also need to be properly designed. The standard should state this.

6. Paragraph 17. Note: Inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.

We recommend that this Note read as follows:

Inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the design and operating effectiveness of a control.

Further, we recommend that this Note be revised to include the AICPA’s standard (at AU 326.35):

“The auditor should perform audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Inquiry alone ordinarily does not provide sufficient appropriate audit evidence to detect a material misstatement at the relevant assertion level.”

7. Paragraph 28. Audit sampling is the application of an audit procedure to less than 100 percent of the occurrences of a control or items comprising an account for the purpose of evaluating some characteristic of the control or account.

We recommend that this definition conform to AU 350 which defines audit sampling as follows:
“Audit sampling is the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class (footnote omitted).”

Question:

17. Does the new proposed standard describe clearly how the auditor should determine the financial statement assertions to use for both integrated audits and audits of financial statements only?

Yes, the proposal provides a cross-reference to AS 5 in footnote 1, but not to the relevant paragraphs (pars. 28-33).

Proposed Amendments to Interim Ethics Standards

Question:

18. Are there provisions in the to-be-superseded standards that should be retained?

No.