



Public Company Accounting Oversight Board

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PROPOSED AUDITING STANDARDS)
RELATED TO THE AUDITOR'S ASSESSMENT)
OF AND RESPONSE TO RISK)
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AND RELATED AMENDMENTS TO PCAOB)
STANDARDS)
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PCAOB Release No. 2009-007
December 17, 2009

PCAOB Rulemaking
Docket Matter No. 026

Summary: The Public Company Accounting Oversight Board (the "Board" or "PCAOB") is reproposing seven auditing standards related to the auditor's assessment of and response to risk. The text of the proposed auditing standards and the related amendments (Appendices 1-8) will be applicable to all registered firms conducting audits in accordance with PCAOB standards and would supersede six of the Board's interim auditing standards.

Public Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 026 in the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on March 2, 2010.

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1. Introduction

The Board is reproposing seven auditing standards ("new proposed standards") that collectively would replace the requirements for assessing and responding to risk during an audit. The existing PCAOB standards regarding risk assessment were developed, for the most part, during the 1980s. The new proposed standards have been informed by a number of factors and developments since that time. These include the risk-based audit methodologies currently used in many audits of issuers; recommendations to the profession on ways in which auditors could improve risk assessment;^{1/} advice from the Board's Standing Advisory Group ("SAG");^{2/} the adoption of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*; and observations from the Board's oversight activities. The provisions in the new proposed standards build upon and attempt to improve the framework established by existing PCAOB standards, rather than replace that framework altogether. Accordingly, while the Board is proposing to supersede several of its interim standards, the concepts underpinning the new proposed standards should be familiar to most auditors.

At the most basic level, the new proposed standards are, like existing PCAOB standards, rooted in the concept of audit risk. In an audit of financial statements, audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. In an audit of financial statements, the auditor's responsibility is to plan and perform the audit to limit audit risk to an appropriately low level, so the auditor can opine with reasonable assurance that the financial statements present fairly, in all material respects, a company's financial

^{1/} See, e.g., Public Oversight Board, Panel on Audit Effectiveness ("PAE"), *Report and Recommendations* (August 31, 2000). For a summary of the PAE's recommendations related to risk assessment, see PCAOB Standing Advisory Group Meeting Briefing Paper, "Risk Assessment in Financial Statement Audits" (February 16, 2005), Appendix A, available at http://www.pcaobus.org/News_and_Events/Events/2005/02-16.aspx.

^{2/} Webcasts of those meetings are available on the Board's website at www.pcaobus.org/News_and_Events/Webcasts.

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position, results of operations, and cash flows in conformity with the applicable financial reporting framework.^{3/}

On October 21, 2008, the Board proposed seven auditing standards to update the requirements for assessing and responding to risk during an audit ("the original proposed standards").^{4/} The original proposed standards were intended to improve the standards for audits of issuers by –

- Enhancing the effectiveness of auditors' assessment of and response to risk, especially in risk-based audits;
- Enhancing integration of the audit of financial statements with the audit of internal control over financial reporting;^{5/}
- Emphasizing the auditor's responsibility for considering the risk of fraud during the audit; and
- Setting an improved foundation for future standard setting.

The original proposed standards also sought to eliminate unnecessary differences between the Board's risk assessment standards and the risk assessment standards of the International Auditing and Assurance Standards Board ("IAASB").^{6/}

^{3/} Paragraph .01 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, indicates that the auditor should look to the requirements of the Securities and Exchange Commission ("SEC") for the company under audit with respect to the accounting principles applicable to that company. The proposed standards use the term "applicable financial reporting framework" to describe the applicable accounting principles.

^{4/} PCAOB Release No. 2008-006, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (October 21, 2008).

^{5/} Other than certain related proposed amendments discussed in this release, the Board is not proposing changes to Auditing Standard No. 5, which was adopted in 2007 after notice and comment and approved by the SEC.

^{6/} After the Board released its original proposal, the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA")

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The Board received 33 comment letters on the original proposed standards.^{7/} Many commenters were supportive of the Board's efforts to update its risk assessment requirements in light of risk-based audit methodologies, to align the fundamental principles from Auditing Standard No. 5 and to eliminate unnecessary differences from the risk assessment standards of the IAASB. A number of commenters expressed support for the Board's emphasis in the original proposed standards on the auditor's responsibilities for considering the risk of fraud. The commenters offered numerous suggestions for changing the original proposed standards, as well as comments about the Board's standards in general and its standards-setting process.^{8/}

After considering all of the comments received on the original proposed standards, the Board has made numerous refinements to the original proposed standards. While evaluating the comments, the Board also identified other opportunities for improvements, which has resulted in further enhancement of the original proposed standards. Because these proposed standards address many fundamental aspects of the audit process and are expected to serve as a foundation for future standards setting, the Board is reproposing the standards for public comment. Subsequent sections of this release discuss areas of emphasis in the new proposed standards and provide an overview of each of the new proposed standards. Appendix 9 discusses changes to existing PCAOB standards resulting from the new proposed standards, responses to comments received on the original proposed standards, and differences between the original proposed standards and the new proposed standards.

2. Areas of Emphasis in the New Proposed Standards

This section discusses aspects of the new proposed standards that received particular attention. Appendix 9 discusses specific changes to the new proposed standards in these areas.

issued a proposed update of its risk assessment standards as part of its clarity project. Appendix 10 compares the new proposed standards to the proposed ASB standards.

^{7/} Comments on the proposal are available on the Board's website at http://www.pcaobus.org/Rules/Docket_026/index.aspx.

^{8/} The Board continuously endeavors to improve its processes, including its standards-setting process, and is considering these comments as it does so.

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A. Alignment with Auditing Standard No. 5

In the release accompanying the original proposed standards, the Board stated its belief that improvements in the requirements related to risk assessment should enhance integration of the audit of the financial statements with the audit of internal control over financial reporting. Because the original proposed standards described requirements for assessing risk, responding to risk, and evaluating audit results that apply to all audits, including integrated audits of financial statements and internal control over financial reporting ("integrated audits"), those proposed standards reflected certain foundational risk assessment principles that are also discussed in Auditing Standard No. 5.

Commenters generally supported this approach and suggested ways to enhance the alignment between the proposed standards and Auditing Standard No. 5. The new proposed standards include additional provisions from Auditing Standard No. 5 related to identifying and assessing risks that apply to financial statement audits. Certain provisions in the original proposed standards have been omitted from the new proposed standards because the provisions relate only to audits of internal control over financial reporting ("audits of internal control").

B. Consideration of Fraud

Like the original proposed standards, the new proposed standards continue to emphasize the auditor's responsibilities for consideration of fraud by incorporating the requirements for identifying and responding to risk of material misstatement due to fraud ("fraud risks") and evaluating audit results from the existing PCAOB standard, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.^{9/} Incorporating these requirements makes clear that the auditor's responsibilities for identifying, assessing, and responding to the risks of material misstatement due to fraud are an integral part of the audit process rather than a separate, parallel process.

The Board has observed from its oversight activities instances in which auditors have performed the procedures required in AU sec. 316 mechanically, without using the

^{9/} Like the original proposed standards, the new proposed standards incorporate paragraphs .14 -.51 and paragraphs .68-.78 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. Accordingly, those paragraphs would be removed from AU sec. 316 by means of a related amendment. See Appendix 8.

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procedures to develop insights on fraud risks or modify the audit plan to address those risks, and instances in which firms have failed to respond appropriately to identified fraud risks. These kinds of deficiencies suggest that some auditors may view the consideration of fraud as an isolated, mechanical process rather than an integral part of audits under PCAOB standards. The approach to integrate relevant requirements from AU sec. 316 would emphasize to auditors that assessing and responding to fraud risks is an integral part of an audit under PCAOB standards, rather than a separate consideration. It is also intended to prompt auditors to make a more thoughtful and thorough assessment of risks affecting the financial statements, including fraud risks, and to develop appropriate audit responses. However, AU sec. 316, with proposed amendments, will continue to provide relevant information on determining the necessary procedures for considering fraud in a financial statement audit.

The new proposed standards contain enhancements to the requirements for consideration of fraud in an audit based on comments received on the original proposed standards and other considerations. Such enhancements include revisions to the requirements regarding consideration of potential bias in financial statements and additional requirements regarding consideration of potential fraud risks related to omitting or presenting incomplete disclosures.

C. Auditing Disclosures

Disclosures have long been an important component of the financial statements, and PCAOB standards recognize that the concept of "present fairly in conformity with general accepted accounting principles" encompasses the principle that "the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation."^{10/} However, many of the provisions regarding disclosures in existing PCAOB standards are limited to discussion of the effects of omitted disclosures on the auditor's report and the evaluation of specific disclosures, e.g., disclosures regarding the company's ability to continue as a going concern.

Based on observations from the Board's oversight activities, the Board believes that enhancing the requirements for evaluating disclosures can prompt auditors to be more thoughtful and thorough in their approach to testing and evaluating disclosures. The new proposed standards contain new requirements and discussion regarding the

^{10/} AU sec. 411.04.

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auditor's responsibilities for evaluating disclosures, which, collectively, would supersede AU sec. 431, *Adequacy of Disclosure in Financial Statements*.

3. Overview of the New Proposed Standards

Like the original proposed standards, the new proposed standards are intended to strengthen the requirements for assessing and responding to risk in an audit to enhance the auditor's focus on the areas of greatest risk. Accordingly, the new proposed standards would improve the requirements for performing procedures to identify and appropriately assess risks of material misstatement due to error or fraud, require appropriate responses to those risks, and enhance the requirements for evaluating the results of the audit. Also, like the original proposed standards, the new proposed standards would apply to all audits performed in accordance with PCAOB standards.

The new proposed standards, which are included in Appendices 1-7 of this release, are as follows:

- Audit Risk^{11/}
- Audit Planning and Supervision
- Consideration of Materiality in Planning and Performing an Audit
- Identifying and Assessing Risks of Material Misstatement
- The Auditor's Responses to the Risks of Material Misstatement
- Evaluating Audit Results
- Audit Evidence

The new proposed standards will supersede six interim auditing standards: AU sec. 311, *Planning and Supervision*, AU sec. 312, *Audit Risk and Materiality in*

^{11/} The original proposed standard was titled *Audit Risk in an Audit of Financial Statements*. The title of the new proposed standard was changed to emphasize the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit and audit of financial statements only.

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Conducting an Audit, AU sec. 313, *Substantive Tests Prior to the Balance Sheet Date*, AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, AU sec. 326, *Evidential Matter*, and AU sec. 431.

In addition to the new proposed standards, the Board is proposing certain related amendments to existing PCAOB standards, which are presented in Appendix 8.

A. Proposed Auditing Standard – Audit Risk

This new proposed standard discusses the components of audit risk in an audit of financial statements and the auditor's consideration of audit risk. These matters are fundamental to PCAOB auditing standards, including the other new proposed standards.

Also, the new proposed standard contains certain revisions and enhancements based on comments received on the original proposed standard and observations from the Board's oversight activities. The original proposed standard has been revised to relate more clearly the concept of audit risk to the opinion on the fair presentation of the financial statements, as expressed in the auditor's report. The new proposed standard also has been enhanced by expanding the discussion of risks of material misstatement at the financial statement level and by clarifying the relationship between detection risk and the performance of substantive procedures.

B. Proposed Auditing Standard – Audit Planning and Supervision

This new proposed standard describes the auditor's responsibilities for planning the audit, including assessing matters that are important to the audit and establishing an appropriate audit strategy and audit plan. The new proposed standard would apply to audits of financial statements only and to integrated audits. It would supersede AU sec. 311.

In developing this new proposed standard, the Board seeks to enhance the requirements for planning and supervision by:

- Explicitly articulating the engagement partner's responsibilities for audit planning and supervision;
- Requiring the auditor to develop an appropriate audit strategy and audit plan based on those matters that are important to the company's financial statements and internal control over financial reporting;

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- Having the auditor focus more on the respective risks when planning multi-location engagements;
- Expanding the requirements for using persons with specialized knowledge and skills in areas in addition to information technology; and
- Tailoring the level of supervision of engagement team members based on, among other things, the risks of material misstatement.

C. Proposed Auditing Standard – Consideration of Materiality in Planning and Performing an Audit

This new proposed standard describes the auditor's responsibilities for applying the concept of materiality, as described by the courts in interpreting federal securities laws, in planning the audit and determining the scope of the audit procedures. Accordingly, the concept of materiality in this new proposed standard reflects the perspective of a reasonable investor.

This new proposed standard contains new and revised requirements for determining materiality for particular accounts or disclosures, determining materiality for individual locations or business units in multi-location engagements, and reassessing materiality and the scope of audit procedures.

D. Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement

This new proposed standard describes the auditor's responsibilities for identifying and assessing risks of material misstatement in an integrated audit and an audit of financial statements only. This proposed standard contains new and revised requirements for performing risk assessment procedures and analyzing identified risks. This proposed standard also incorporates the auditor's responsibilities for identifying and assessing fraud risks so auditors will integrate their consideration of fraud into their risk assessments. The resulting risk assessments should drive the auditor's testing procedures so that auditors focus their attention on the areas of greatest risk.

Establishing more rigorous requirements for identifying and assessing risks can improve auditors' risk assessments and ability to focus on areas of increased risk in audits of financial statements only and in integrated audits. The effectiveness of a risk-based audit depends on whether the auditor identifies the risks of material misstatement

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and has an appropriate basis for assessing those risks. Inappropriate identification or assessment of risks of material misstatements can lead to overlooking relevant risks to the financial statements, e.g., business conditions that affect asset quality or create pressures to manipulate the financial statements, or assessing risks too low without having an appropriate basis for the assessment. In turn, these situations can lead to misdirected or inadequate audit work.

This new proposed standard employs a top-down approach to risk assessment. Such an approach 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. Also, the procedures in the new proposed standard are designed to be scalable to companies of varying size and complexity.

In an integrated audit, the risks of material misstatement affect both the audit of financial statements and the audit of internal control, so the risk assessment process described in this new proposed standard is for a single process that applies to both the audit of financial statements and the audit of internal control. The new proposed standard seeks to enhance the integration of the audit of financial statements with the audit of internal control by aligning these risk assessment standards closely with Auditing Standard No. 5. Accordingly, the new proposed standard reflects certain foundational risk assessment principles from Auditing Standard No. 5 that also apply to audits of financial statements. On the other hand, the provisions of this new proposed standard also are designed to be tailored for audits of financial statements only, e.g., the provisions relating to the understanding of internal control over financial reporting.

E. Proposed Auditing Standard – The Auditor's Responses to the Risks of Material Misstatement

The new proposed standard describes the auditor's responsibilities for responding to the risks of material misstatement.

An effective risk-based audit involves tailoring the general conduct of the audit and designing and performing audit procedures in a manner that is appropriately directed to the risks of material misstatement. In developing the original proposed standard, the Board sought to direct auditors to conduct their audits in a manner that appropriately responds to those risks.

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The new proposed standard requires the auditor to respond to the risks of material misstatement through overall responses and responses involving the nature, timing, and extent of audit procedures. Overall responses relate to the general conduct of the audit, e.g., appropriate assignment and supervision of engagement team members, incorporating an element of unpredictability into the audit, and making pervasive changes to the audit. AU sec. 316, requires such responses for fraud risks, but the new proposed standard would extend the requirement to apply to risks of material misstatement due to error or fraud. These responses, by their nature, are appropriate for addressing risks of material misstatement due to error or fraud.

The new proposed standard requires the auditor to perform audit procedures that adequately address the assessed risks of material misstatement due to error or fraud. The new proposed standard establishes specific requirements for determining the necessary nature, timing, and extent of substantive procedures and tests of controls (when such tests of controls are performed).

F. Proposed Auditing Standard – Evaluating Audit Results

This new proposed standard describes the auditor's responsibilities regarding evaluating the results of the audit and determining whether sufficient appropriate audit evidence has been obtained to form the opinion(s) to be presented in the auditor's report. This new proposed standard consolidates into one auditing standard the requirements that are currently included in five separate auditing standards^{12/} to highlight matters that are important to the auditor's conclusions about the financial statements and the effectiveness of internal control over financial reporting.

This new proposed standard contains several enhancements to the requirements regarding accumulating misstatements and evaluating uncorrected misstatements, including new or revised provisions related to accumulating misstatements, and determining misstatements in accounting estimates. The standard includes new and

^{12/} AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, regarding evaluating audit results, including uncorrected misstatements; AU sec. 316, regarding fraud considerations that are relevant to the evaluating audit results; AU sec. 326, *Evidential Matter*, regarding determining whether sufficient appropriate audit evidence has been obtained; AU sec. 329, *Analytical Procedures*, regarding performing the overall review; and AU sec. 431, *Adequacy of Disclosure in Financial Statements*, regarding the evaluation of financial statement disclosures.

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revised requirements regarding evaluating the qualitative aspects of the company's accounting practices, including potential management bias in accounting estimates and selective correction or netting of uncorrected misstatements.

The new proposed standard specifically requires the auditor to evaluate whether the financial statements are fairly presented, in all material respects, in conformity with the applicable financial reporting framework, including whether the financial statements contain the required disclosures. Existing PCAOB standards express such requirements in terms of the auditor's reporting responsibilities instead of required audit procedures.

The new proposed standard also requires the auditor to conclude regarding whether the auditor has obtained sufficient appropriate audit evidence. This requirement includes consideration of whether the auditor's risk assessments remain appropriate, including whether information obtained during the audit indicates previously unrecognized fraud risks.

G. Proposed Auditing Standard – Audit Evidence

This new proposed standard describes the auditor's responsibilities regarding designing and performing audit procedures to obtain sufficient appropriate evidence to support the opinion(s) in the auditor's report. In particular, the new proposed standard discusses the principles for determining the sufficiency and appropriateness of audit evidence, including information produced by the company. It also contains new and revised requirements for situations in which there are inconsistencies in or doubts about audit evidence. The new proposed standard also contains new and revised requirements regarding selecting items for testing.

4. Effective Date

The original proposed standards did not include a proposed effective date for the proposed standards and related amendments. However, commenters provided their views on how the effective date should be determined. Some commenters indicated that the effective date should be set so that it provides sufficient time for audit firms to update their training, methodologies, and tools. Some commenters suggested specific guidelines for determining the effective date of the standards and asked the Board to propose an effective date to seek public comment.

After considering the suggestions of the commenters and the potential timetable for adoption of final risk assessment standards, the Board expects that the standards

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would be effective for audits of fiscal years beginning on or after December 15, 2010, subject to approval by the SEC.

5. Questions

The Board requests comment on all aspects of the new proposed standards and the related amendments to PCAOB standards. Appendix 9 of this release contains questions on specific aspects of the new proposed standards.

6. Opportunity for Public Comment

The Board will seek comment on the new proposed standards and related amendments for a 75-day period. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, DC 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 026 on the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on March 2, 2010.

* * *

On the 17th day of December, in the year 2009, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Secretary

Proposed Auditing Standard

Audit Risk

Introduction

1. This standard discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit and an audit of financial statements only.^{1/}

Objective

2. The objective of the auditor is to conduct the audit of the financial statements in a manner that reduces audit risk to an appropriately low level.

Audit Risk

3. To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement^{2/} due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.^{3/}

4. In an audit of financial statements, audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, i.e., the financial statements are not presented fairly in conformity with the applicable financial

^{1/} Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, explains how the auditor's consideration of risk affects an audit of internal control over financial reporting.

^{2/} Misstatement is defined in paragraph A2 of Appendix A of Proposed Auditing Standard, *Evaluating Audit Results*.

^{3/} See AU sec. 110, *Responsibilities and Functions of the Independent Auditor*, and AU sec. 230, *Due Professional Care in the Performance of Work*, for a further discussion of reasonable assurance.

reporting framework.^{4/} This risk is a function of the risk of material misstatement and detection risk.

Risk of Material Misstatement

5. The risk of material misstatement refers to the risk that the financial statements are materially misstated, i.e., the financial statements are not presented fairly in conformity with the applicable financial reporting framework. Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, indicates that the auditor should assess the risks of material misstatement at two levels: at the overall financial statement level ("financial statement level") and at the financial statement assertion^{5/} level ("assertion level").

6. Risks of material misstatement at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Examples of conditions that might result in risks of material misstatement at the financial statement level include an ineffective control environment, a lack of sufficient capital to continue operations, and declining conditions affecting the company's industry. Risks of material misstatement at the financial statement level may be especially relevant to the auditor's consideration of the risks of material misstatement due to fraud, e.g., deficiencies in the control environment that increase opportunities for management override of controls.

7. Risk of material misstatement at the assertion level consists of the following components:

- a. *Inherent risk*, which refers to the susceptibility of an assertion to a misstatement, due to error or fraud, that could be material, individually or in combination with other misstatements, before consideration of any related controls.
- b. *Control risk*, which is the risk that a misstatement due to error or fraud that could occur in an assertion and that could be material, individually or in

^{4/} The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

^{5/} See Proposed Auditing Standard, *Audit Evidence*, for a description of financial statement assertions.

combination with other misstatements, will not be prevented or detected on a timely basis by the company's internal control. Control risk is a function of the effectiveness of the design and operation of internal control.

8. Inherent risk and control risk are the company's risks; they exist independently of the audit.

Detection Risk

9. In the audit of the financial statements, detection risk is the risk that the procedures performed by the auditor will not detect a misstatement that exists and that could be material, individually or in combination with other misstatements. The level of detection risk is reduced by performing substantive procedures.^{6/} Detection risk is affected by the effectiveness of the substantive procedures and of their application by the auditor.

10. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the risk of material misstatement at the assertion level. The lower the risk of material misstatement, the greater the detection risk that can be accepted. Conversely, the greater the risk of material misstatement, the less the detection risk that can be accepted. As the acceptable level of detection risk decreases, the assurance provided from substantive tests should increase.

^{6/} Paragraph 37 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

Proposed Auditing Standard

Audit Planning and Supervision

Introduction

1. This standard establishes requirements and provides direction regarding planning the audit and supervising the work of engagement team members.

Objective

2. The objective of the auditor is to plan the audit and supervise the engagement team so that the audit is conducted effectively.

Responsibility of the Engagement Partner for Planning and Supervision

3. The **engagement partner**^{1/} is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for planning the audit and for supervising other engagement team members. The engagement partner may seek assistance from appropriate engagement team members in fulfilling these responsibilities.

Planning an Audit

4. The auditor should properly plan the audit. Paragraphs 5-21 describe the auditor's responsibilities for properly planning the audit.

5. Planning the audit includes establishing the overall audit strategy for the engagement and developing an audit plan, which includes, in particular, planned risk assessment procedures and planned responses to the risks of material misstatement. Planning is not a discrete phase of an audit but, rather, a continual and iterative process that might begin shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.

^{1/} Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

Preliminary Engagement Activities

6. The auditor should perform the following activities at the beginning of the audit:
- a. Perform procedures regarding the continuance of the client relationship and the specific audit engagement;^{2/}
 - b. Determine compliance with independence and ethics requirements; and
 - c. Establish an understanding with the client regarding the services to be performed on the engagement.^{3/}

Note: The decision regarding continuance of the client relationship and the determination of compliance with independence and ethics requirements are not limited to preliminary engagement activities and should be re-evaluated with changes in circumstances.

Planning Activities

7. The nature and extent of planning activities that are necessary depend on the size and complexity of the company, the auditor's previous experience with the company, and changes in circumstances that occur during the audit. When developing the audit strategy and audit plan as discussed in paragraphs 8-10, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures:

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;

^{2/} Paragraphs .14-.16 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*. AU sec. 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* explains how the quality control standards relate to the conduct of audits.

^{3/} AU sec. 310, *Appointment of the Independent Auditor*.

- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality,^{4/} risk, and other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee^{5/} or management;
- Legal or regulatory matters of which the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;
- Preliminary judgments about the effectiveness of internal control over financial reporting;
- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;
- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and
- The relative complexity of the company's operations.

^{4/} Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*.

^{5/} If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company. See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

Audit Strategy

8. The auditor should establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.
9. In establishing the overall audit strategy, the auditor should take into account:
 - a. The reporting objectives of the engagement and the nature of the communications required by PCAOB standards,
 - b. The factors that are significant in directing the activities of the engagement team,
 - c. The results of preliminary engagement activities and the auditor's evaluation of the important matters in accordance with paragraph 7 of this standard, and
 - d. The nature, timing, and extent of resources necessary to perform the engagement.

Audit Plan

10. The auditor should develop and document an audit plan that includes a description of:

- a. The planned nature, timing, and extent of the risk assessment procedures,^{6/}
- b. The planned nature, timing, and extent of tests of controls and substantive procedures,^{7/} and
- c. Other planned audit procedures that are required to be performed so that the engagement complies with PCAOB standards.

Multi-location Engagements

11. In an audit of the financial statements of a company with operations in multiple locations or business units, the auditor should determine the extent to which auditing procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The auditor should assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit.

12. Factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures include:

- a. The nature and amount of assets, liabilities, and transactions executed at the location or business unit;
- b. The materiality of the location or business unit;^{8/}

^{6/} Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

^{7/} Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

^{8/} Paragraph 10 of Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*.

- c. The specific risks associated with the location or business unit that present a reasonable possibility^{9/} of material misstatement to the company's consolidated financial statements;
- d. Whether the risks of material misstatement associated with the location or business unit apply to other locations or business units such that, in combination, they present a reasonable possibility of material misstatement to the company's consolidated financial statements;
- e. The degree of centralization of records or information processing;
- f. The effectiveness of the control environment, particularly with respect to management's control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or business unit; and
- g. The frequency, timing, and scope of monitoring activities by the company or others at the location or business unit.

Note: When performing an audit of internal control over financial reporting, refer to paragraphs B10-B16 of Appendix B, Special Topics, of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, for considerations when a company has multiple locations or business units.

13. In determining the locations or business units at which to perform auditing procedures, the auditor may take into account relevant activities performed by internal audit or others in accordance with AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, and Auditing Standard No. 5. For example, if the internal auditors' planned procedures include relevant audit work at various locations, the auditor may coordinate work with the internal auditors and reduce the number of locations or

^{9/} There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

business units at which the auditor would otherwise need to perform auditing procedures.

14. The direction in paragraph 5 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, regarding incorporating an element of unpredictability in the auditing procedures means that the auditor should vary the nature, timing, and extent of audit procedures at locations or business units from year to year.

Changes During the Course of the Audit

15. The auditor should modify the overall audit strategy and the audit plan as necessary if circumstances change significantly during the course of the audit, including due to a revised assessment of the risks of material misstatement or the discovery of a previously unidentified risk of material misstatement.

Persons with Specialized Skill or Knowledge

16. The auditor should determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, apply the planned audit procedures, or evaluate audit results.

Note: For purposes of the requirements in paragraphs 16-17, the term "specialized skill or knowledge" refers to persons engaged or employed by the auditor who have specialized skill or knowledge.

17. If a person with specialized skill or knowledge employed or engaged by the auditor participates in the audit, the auditor should have sufficient knowledge of the subject matter to be addressed by such a person to enable the auditor to:

- a. Communicate the objectives of that person's work;
- b. Determine whether that person's procedures meet the auditor's objectives; and
- c. Evaluate the results of that person's procedures as they relate to the nature, timing, and extent of other planned audit procedures and the effects on the auditor's report.

18. The requirements for supervision in this standard apply to supervision of a person with specialized skill or knowledge who participates in the audit and is either (a) employed by the auditor or (b) engaged by the auditor to provide

services in a specialized area of accounting or auditing, e.g., an information technology specialist or income tax specialist.

19. AU sec. 336 sets forth the requirements for using the work of persons with specialized skill or knowledge in a field other than accounting or auditing who are engaged by the auditor. Those requirements include, among other things, procedures to understand the objectives and scope of the specialist's work, determine the appropriateness of using the specialist's work for the intended purpose, and evaluate whether the specialist's findings support the related assertions in the financial statements.^{10/}

Additional Considerations in Initial Audits

20. The auditor should undertake the following activities before starting an initial audit:

- a. Perform procedures regarding the acceptance of the client relationship and the specific audit engagement; and
- b. Communicate with the predecessor auditor, in situations in which there has been a change of auditors, in accordance with AU sec. 315, *Communications Between Predecessor and Successor Auditors*.

21. The purpose and objective of planning the audit are the same whether the engagement is an initial audit or a recurring audit engagement. However, for an initial audit, the auditor should determine the additional planning activities necessary to establish an appropriate audit strategy and audit plan, including determining the audit procedures necessary to obtain sufficient appropriate audit evidence regarding the opening balances.

Supervision

22. The auditor should properly supervise the members of the engagement team. Paragraphs 23 and 24 describe the auditor's responsibilities for proper supervision.

23. Elements of proper supervision include the following:

^{10/} See AU secs. 336.09 and .12.

- a. Informing engagement team members of their responsibilities and the objectives of the procedures that they are to perform, and other matters that could affect the nature, timing, and extent of procedures they are to perform or the evaluation of the results of those procedures, including the nature of the company's business as it relates to their assignments^{11/} and possible accounting and auditing issues;
 - b. Directing engagement team members to bring significant accounting and auditing issues arising during the audit to the engagement partner's attention so those issues can be assessed and appropriate actions can be taken;^{12/} and
 - c. Reviewing the work of engagement team members to evaluate whether the work was performed and documented, the objectives of the procedures were achieved, and the results of the work support the conclusions reached.
24. Factors that affect the necessary level of supervision of other engagement team members include the following:
- The size and complexity of the company
 - The nature of the assigned work for each team member, including the procedures to be performed and the controls or accounts and disclosures to be tested

^{11/} Paragraph .06 of AU sec. 230, *Due Professional Care in the Performance of Work*, and Paragraph 5 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, establish requirements and provide direction regarding the appropriate assignment of engagement team members.

^{12/} In applying due professional care in accordance with AU sec. 230, each engagement team member has a responsibility to bring to the attention of appropriate persons, disagreements or concerns the engagement team member might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or auditor's report, however those disagreements or concerns may have arisen.

- The risks of material misstatement^{13/}
- The knowledge, skill, and ability of each team member

^{13/} Paragraph 5 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, indicates that the level of supervision of engagement team members is part of the auditor's overall responses to the risks of material misstatement.

APPENDIX A – Definition

- A1. For purposes of this standard, the term listed below is defined as follows:
- A2. Engagement partner – The member of the engagement team with primary responsibility for the audit.

Proposed Auditing Standard

Consideration of Materiality in Planning and Performing an Audit

Introduction

1. This standard establishes requirements and provides direction regarding the auditor's consideration of materiality in planning and performing an audit.

Note: Proposed Auditing Standard, *Evaluating Audit Results*, establishes requirements and provides direction regarding the auditor's consideration of materiality in evaluating audit results.

Materiality in the Context of an Audit

2. 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." (TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).) 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" TSC Industries, 426 U.S. at 450.

3. To obtain reasonable assurance about whether the financial statements are free of material misstatement, the auditor should design and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements. This includes being alert while performing audit procedures for misstatements that could be material due to quantitative or qualitative factors. Also, the evaluation of uncorrected misstatements in accordance with Proposed Auditing Standard, *Evaluating Audit Results*, requires consideration of both qualitative and quantitative factors.^{1/} However, it ordinarily is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors.

^{1/} Appendix B of Proposed Auditing Standard, *Evaluating Audit Results*.

4. For integrated audits, paragraph 20 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, states, "In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements."

Objective

5. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing audit procedures.

Considering Materiality When Planning and Performing the Audit

Materiality for the Financial Statements as a Whole

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.

Note: If financial statements for the audit period are not available, the auditor may establish an initial materiality level based on estimated or preliminary financial statement amounts. In those situations, the auditor should take into account the effects of known or expected changes in the company's financial statements, including significant transactions or adjustments that are expected to be reflected in the financial statements at the end of the period.

Materiality for Particular Accounts or Disclosures

7. 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.

Note: 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.

Determining Tolerable Misstatement

8. The auditor should determine the amount or amounts of tolerable misstatement^{2/} 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, 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.

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.

Considerations for Multi-Location Engagements

10. For purposes of the audit of the consolidated financial statements of a company with multiple locations or business units, the auditor should establish the materiality level to be used in performing audit procedures at the locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements. Accordingly, materiality at an individual location cannot exceed, and generally should be less than, materiality for the financial statements as a whole.

^{2/} Paragraph .18 of AU sec. 350, *Audit Sampling*, indicates that tolerable misstatement is the maximum amount of misstatement in an account or a class of transactions that may exist without causing the financial statements to be materially misstated.

Considerations as the Audit Progresses

11. The auditor should reassess the established materiality level or levels and tolerable misstatement when, 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. Situations in which changes in circumstances would require such reassessment include:

- a. The materiality level or levels and tolerable misstatement were established initially based on estimated or preliminary financial statement amounts that differ significantly from actual amounts at the end of the period covered by the financial statements
- 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.

12. If the auditor's reassessment results in a lower amount for the materiality level or levels or tolerable misstatement than the auditor's initial determination, the auditor should (1) evaluate the effect, if any, of the lower amount or amounts on his or her risk assessments and audit procedures and (2) modify the nature, timing, and extent of audit procedures as necessary to obtain sufficient appropriate audit evidence.

Note: The reassessment of the materiality level or levels and tolerable misstatement is also relevant to the auditor's evaluation of uncorrected misstatements in accordance with paragraph 17 of Proposed Auditing Standard, *Evaluating Audit Results*.

Proposed Auditing Standard

Identifying and Assessing Risks of Material Misstatement

Introduction

1. This standard establishes requirements and provides direction regarding the process of identifying and assessing risks of material misstatement^{1/} of the financial statements.
2. Paragraphs 4-55 discuss the auditor's responsibilities for performing **risk assessment procedures**.^{2/} Paragraphs 56-73 discuss identifying and assessing the risks of material misstatement using information obtained from the risk assessment procedures.

Objective

3. The objective of the auditor is to identify and appropriately assess the risks of material misstatement, thereby providing a basis for designing and implementing responses to the risks of material misstatement.

Performing Risk Assessment Procedures

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^{3/} and to design further audit procedures.^{4/}

^{1/} Paragraphs 5-8 of Proposed Auditing Standard, *Audit Risk*.

^{2/} Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

^{3/} AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, discusses fraud, its characteristics, and the types of misstatements due to fraud that are relevant to the audit, i.e., misstatements arising from fraudulent financial reporting and misstatements arising from asset misappropriation.

^{4/} Proposed Auditing Standard, *Audit Evidence*, describes further audit procedures as consisting of tests of controls and substantive procedures.

5. 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, for example, 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 discusses the following risk assessment procedures:

- a. Obtaining an understanding of the company and its environment (paragraphs 7-17);
- b. Obtaining an understanding of internal control over financial reporting (paragraphs 18-37);
- c. Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company (paragraphs 38-42);
- d. Performing analytical procedures (paragraphs 43-45);
- e. Conducting a discussion among engagement team members regarding the risks of material misstatement (paragraphs 46-50); and
- f. Inquiring of the audit committee, management, and others within the company about the risks of material misstatement (paragraphs 51-55).

Note: This standard describes a top-down approach to identifying and assessing risks of material misstatement. A top-down approach 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.^{5/}

6. In an integrated audit, the risks of material misstatement of the financial statements are the same for both the audit of internal control over financial reporting and the audit of the financial statements. The auditor's risk assessment procedures should apply to both the audit of internal control over financial reporting and the audit of the financial statements.

Obtaining an Understanding of the Company and Its Environment

7. The auditor should obtain an understanding of the company and its environment ("understanding of the company") to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. Obtaining an understanding of the company includes understanding the following:

- a. Relevant industry, regulatory, and other external factors;
- b. The nature of the company;
- c. The company's selection and application of accounting principles, including related disclosures;
- d. The **company's objectives** and strategies and those related **business risks** that might reasonably be expected to result in risks of material misstatement; and
- e. The company's measurement and review of its financial performance.

8. While obtaining an understanding of the company, the auditor should evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement.

^{5/} Paragraph 11 of Proposed Auditing Standard, *Audit Evidence*, discusses financial statement assertions.

Industry, Regulatory, and Other External Factors

9. Obtaining an understanding of relevant industry, regulatory, and other external factors encompasses industry factors including the competitive environment and technological developments; the regulatory environment, including the applicable financial reporting framework^{6/} and the legal and political environment;^{7/} and external factors including general economic conditions.

Nature of the Company

10. Obtaining an understanding of the nature of the company includes understanding the following:

- The company's organizational structure and management personnel;
- The sources of funding of the company's operations and investment activities, including the company's capital structure, non-capital funding (e.g., subordinated debt or dependencies on supplier financing), and other debt instruments;
- The company's significant investments including equity method investments, joint ventures, and variable interest entities;
- The company's operating characteristics, including its size and complexity;

Note: The size and complexity of a company might affect the risks of misstatement and how the company addresses those risks.

- The sources of the company's earnings, including the relative profitability of key products and services; and

^{6/} The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

^{7/} See AU sec. 317, *Illegal Acts by Clients*, for additional direction regarding the auditor's consideration of laws and regulations relevant to the audit.

- Key supplier and customer relationships.

Note: 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*.

11. The auditor also should consider performing the following procedures as part of obtaining an understanding of the company:

- Reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting, e.g., company-issued press releases, company-prepared presentation materials for analysts or investor groups, and analyst reports;
- Observing or reading transcripts of earnings calls and, to the extent publicly available, other meetings with investors or rating agencies;
- Obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements; changes or adjustments to those arrangements and special bonuses; and
- Obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders to identify potentially significant unusual developments (e.g., from Forms 3, 4, 5, 13D, and 13G).

Selection and Application of Accounting Principles

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

13. 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 is 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 or incomplete disclosures, the auditor should identify the necessary disclosures for the company's financial statements.

Company Objectives, Strategies, and Related Business Risks

14. The purpose of obtaining an understanding of the company's objectives, strategies, and related business risks is to identify those business risks that could reasonably be expected to result in material misstatement of the financial statements.

15. The following are examples of situations in which business risks might result in material misstatement of the financial statements:

- Industry developments (a potential related business risk might be, for example, that the company does not have the personnel or expertise to deal with the changes in the industry.)

- New products and services (a potential related business risk might be, for example, that the new product or service will not be successful.)
- Use of information technology (a potential related business risk might be, for example, that systems and processes are incompatible.)
- New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation.)
- Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated.)
- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation.)
- Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the company's inability to meet requirements.)
- Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure.)

Note: Some relevant business risks might be identified through other risk assessment procedures, such as obtaining an understanding of the nature of the company and understanding industry, regulatory, and other external factors.

Company Performance Measures

16. The purpose of obtaining an understanding of the company's performance measures is to identify those performance measures, whether external or internal, that affect the risks of material misstatement.

17. The following are examples of performance measures that might affect the risks of material misstatement:

- Measures that form the basis for contractual commitments or incentive compensation arrangements
- Measures used by external parties, such as analysts and rating agencies, to review the company's performance
- Measures the company uses to monitor its operations that highlight unexpected results or trends prompting management to investigate their cause and take corrective action, including correction of misstatements

Note: 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.

Obtaining an Understanding of Internal Control Over Financial Reporting

18. The auditor should obtain a sufficient understanding of each component^{8/} of internal control over financial reporting ("understanding of internal control") to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.

19. The nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control depend on the size and complexity of the company;^{9/} the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's controls, including the

^{8/} Paragraphs 21-22 of this standard discuss components of internal control.

^{9/} Paragraph 13 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with and Audit of Financial Statements*, states, "The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its control objectives. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks."

company's use of information technology ("IT"); the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting.

Note: The auditor also might obtain an understanding of certain controls that are not part of internal control over financial reporting, e.g., controls over the completion and accuracy of operating or other non-financial information used as audit evidence.^{10/}

Note: Walkthroughs, as described in paragraphs 64-65, may be performed in connection with obtaining an understanding of internal control.

20. Obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.

Note: Procedures the auditor performs to obtain evidence about design effectiveness include inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Note: Determining whether a control has been implemented means determining whether the control exists and whether the company is using it. The procedures to determine whether a control has been implemented may be performed in connection with the evaluation of its design. Procedures performed to determine whether a control has been implemented include inquiry of company personnel, in combination with observation of the application of controls or inspection of documentation.

21. Internal control over financial reporting can be described as consisting of the following components:^{11/}

^{10/} Paragraph 10 of Proposed Auditing Standard, *Audit Evidence*.

^{11/} Different internal control frameworks use different terms and approaches to describe the components of internal control over financial reporting.

- The control environment
- The company's risk assessment process
- Information and communication
- Control activities
- Monitoring of controls

22. Management might use an internal control framework that differs from the components identified in the preceding paragraph when establishing and maintaining the company's internal control over financial reporting. In evaluating the design of controls and determining whether they have been implemented in an audit of financial statements only, the auditor may use the framework used by management or another suitable, recognized framework.^{12/} For integrated audits, Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, states, "The auditor should use the same suitable, recognized control framework to perform the audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting."^{13/} If the auditor uses a suitable, recognized internal control framework with components that differ from those listed in the preceding paragraph, the auditor should adapt the requirements in paragraphs 23-35 of this standard to conform to the components in the framework used.

Control Environment

23. The auditor should obtain an understanding of the company's control environment, including the policies and actions of management, the board, and the audit committee concerning the company's control environment.

24. Obtaining an understanding of the control environment includes assessing the following:

^{12/} See Securities Exchange Act Release No. 34-47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

^{13/} Paragraph 5 of Auditing Standard No. 5.

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

Note: In an audit of financial statements only, this assessment may be based on the evidence obtained in understanding the control environment, in accordance with paragraph 23, and the other relevant knowledge possessed by the auditor. In an integrated audit of financial statements and internal control over financial reporting, paragraph 25 of Auditing Standard No. 5 describes the auditor's responsibility for evaluating the control environment.

25. If the auditor identifies a control deficiency in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor, as discussed in paragraphs 66-67.

The Company's Risk Assessment Process

26. The auditor should obtain an understanding of management's process for:
- a. Identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud ("fraud risks"),
 - b. Assessing the likelihood and significance of misstatements resulting from those risks, and
 - c. Deciding about actions to address those risks.
27. Obtaining an understanding of the company's risk assessment process includes obtaining an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.

Information and Communication

28. *Information System Relevant to Financial Reporting.* The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following:

- a. The classes of transactions in the company's operations that are significant to the financial statements;
- b. The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported;
- c. The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, authorize, process, and record transactions;
- d. How the information system captures events and conditions, other than transactions,^{14/} that are significant to the financial statements; and
- e. The period-end financial reporting process.

Note: Appendix B discusses additional considerations regarding manual and automated systems and controls.

29. A company's business processes are the activities designed to:
- a. Develop, purchase, produce, sell and distribute a company's products and/or services;
 - b. Record information, including accounting and financial reporting information; and
 - c. Ensure compliance with laws and regulations relevant to the financial statements.

^{14/} Examples of such events and conditions include depreciation and amortization and conditions affecting the recoverability of assets.

30. Obtaining an understanding of the company's business processes, assists the auditor in obtaining an understanding of how transactions are initiated, authorized, processed, and recorded.

31. A company's period-end financial reporting process, as referred to in paragraph 28e, includes the following:

- Procedures used to enter transaction totals into the general ledger;
- Procedures related to the selection and application of accounting policies;^{15/}
- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- Procedures used to record recurring and nonrecurring adjustments to the annual financial statements (and quarterly financial statements, if applicable); and
- Procedures for preparing annual financial statements and related disclosures (and quarterly financial statements, if applicable).

32. *Communication.* The auditor should obtain an understanding of how the company communicates financial reporting roles and responsibilities and significant matters relating to financial reporting including:

- Communications between management, the audit committee and the board; and
- Communications to external parties, including regulatory authorities and shareholders.

Control Activities

33. The auditor should obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures, as described in paragraph 18.^{16/}

^{15/} See paragraphs 12-13 of this standard.

^{16/} See also paragraph B5 of Appendix B.

Monitoring of Controls

34. The auditor should obtain an understanding of the major types of activities that the company uses to monitor the effectiveness of its internal control over financial reporting and how the company initiates corrective actions related to its controls.

Note: In some companies, internal auditors or others performing an equivalent function contribute to the monitoring of controls. AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, establishes requirements and provides direction regarding the auditor's consideration and use of the work of the internal audit function.

35. An understanding of the company's monitoring activities includes understanding the source of the information used in the monitoring activities.

Relationship of Understanding of Internal Control to Tests of Controls

36. 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.^{18/} The auditor may obtain an understanding of internal control concurrently with performing tests of controls if he or she obtains sufficient appropriate evidence to achieve the objectives of both procedures. Also, the auditor should take into account the evidence obtained from understanding internal control when assessing control risk and, in the audit of internal control over financial reporting, forming conclusions about the effectiveness of controls.

37. *Relationship of Understanding of Internal Control to Evaluating Entity-Level Controls in an Audit of Internal Control Over Financial Reporting.* Paragraph 22 of Auditing Standard No. 5 states, "The auditor must test those entity-level controls that are important to the auditor's conclusion about whether

^{17/} Paragraphs 16-31 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

^{18/} Paragraph B1 of Auditing Standard No. 5.

the company has effective internal control over financial reporting." The procedures performed to obtain an understanding of certain components of internal control in accordance with this standard, e.g., the control environment, the company's risk assessment process, information and communication, and monitoring of controls, might provide evidence that is relevant to the auditor's evaluation of entity-level controls.^{19/} The auditor should take into account the evidence obtained from understanding internal control when determining the nature, timing, and extent of procedures necessary to support the auditor's conclusions about the effectiveness of entity-level controls in the audit of internal control over financial reporting.

Considering Information from the Client Acceptance and Retention Evaluation, Audit Planning Activities, Past Audits, and Other Engagements

38. *Client Acceptance and Retention and Audit Planning Activities.* The auditor should evaluate whether information obtained from the client acceptance and retention process or audit planning activities is relevant to identifying risks of material misstatement. Risks of material misstatement identified during those activities should be assessed as discussed in paragraphs 56-73 of this standard.

39. *Past Audits.* In subsequent years, the auditor should incorporate knowledge obtained during past audits into the auditor's process for identifying risks of material misstatement, including when identifying significant ongoing matters that affect the risks of material misstatement or determining how changes in the company or its environment affect the risks of material misstatement, as discussed in paragraph 8 of this standard.

40. If the auditor plans to limit the nature, timing, or extent of his or her risk assessment procedures by relying on information from past audits, the auditor should determine that the prior-years' information remains relevant and reliable.

41. *Other Engagements.* When the auditor has performed a review of interim financial information in accordance with AU sec. 722, *Interim Financial Information*, the auditor should evaluate whether information obtained during the

^{19/} The entity-level controls listed in paragraph 24 of Auditing Standard No. 5 include controls related to the control environment; the company's risk assessment process; centralized processing and controls; controls over the period-end financial reporting process; and controls to monitor other controls.

review is relevant to identifying risks of material misstatement in the year-end audit.

42. If the auditor has obtained other information relevant to identifying risks of material misstatement through other engagements performed for the company, the auditor should take that into account in identifying risks of material misstatement.^{20/}

Performing Analytical Procedures

43. The auditor should perform analytical procedures that are designed to:
- a. Enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior year-end; and
 - b. Identify areas that might represent specific risks relevant to the audit, including the existence of unusual transactions and events, and amounts, ratios, and trends that warrant investigation.

44. In applying analytical procedures as risk assessment procedures, the auditor should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud. Also, when the auditor has performed a review of interim financial information in accordance with AU sec. 722, he or she should take into account the analytical procedures applied in that review when designing and applying analytical procedures as risk assessment procedures.

45. When applying an analytical procedure, the auditor should use his or her understanding of the company to develop expectations about plausible relationships among the data to be used in the procedure.^{21/} When comparison of those expectations with relationships derived from recorded amounts yields

^{20/} Paragraph 7 of Proposed Auditing Standard, *Audit Planning and Supervision*.

^{21/} Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.

unusual or unexpected results, the auditor should take into account those results in identifying the risks of material misstatement.

Note: Analytical procedures performed as risk assessment procedures often use data aggregated at a high level and ordinarily are not designed with the level of precision necessary for substantive analytical procedures.

Conducting a Discussion among Engagement Team Members Regarding Risks of Material Misstatement

46. 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.^{22/}

Note: 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. See paragraphs 49-50 of this standard.

47. Key engagement team members include all engagement team members who have significant engagement responsibilities, including the engagement partner. The manner in which the discussion may be conducted depends on the individuals involved and the circumstances of the engagement. For example, if the audit involves more than one location, there could be multiple discussions with team members in differing locations. The engagement partner or other key engagement team members should communicate the important matters from the discussion to engagement team members who are not involved in the discussion.

Note: If the audit is performed entirely by the engagement partner, that engagement partner, having personally conducted the planning of the audit, is responsible for considering the susceptibility of the company's financial statements to material misstatement.

^{22/} For example, the financial statements might be susceptible to misstatement through omission of required disclosures or presentation of incorrect or incomplete disclosures.

48. Communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change.^{23/}

Discussion of the Potential for Material Misstatement Due to Fraud

49. 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 disclosures
- A consideration of the known external and internal factors affecting the company that might (a) create incentives or pressures for management and others to commit fraud, (b) provide the opportunity for fraud to be perpetrated, and (c) indicate a culture or environment that enables management to rationalize committing fraud
- A consideration of the risk of management override
- A consideration of the potential audit responses to the susceptibility of the company's financial statements to material misstatement due to fraud

^{23/} See also paragraph 29 of Proposed Auditing Standard, *Evaluating Audit Results*.

50. The auditor should emphasize the following matters to all engagement team members:

- The need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, as described in paragraph 13 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*
- The need to be alert for information or other conditions (such as those presented in paragraph C1 of Proposed Auditing Standard, *Evaluating Audit Results*) that might affect the assessment of fraud risks
- If information or other conditions indicate a material misstatement due to fraud might have occurred, the need to probe the issues, acquire additional evidence as necessary, and consult with other team members and, if appropriate, others in the firm including specialists^{24/}

Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

51. The auditor should make inquiries of the audit committee (or its chair), management, the internal audit function, and others within the company who might reasonably be expected to have information that is important to the identification and assessment of risks of material misstatement.

Note: The auditor's inquiries about risks of material misstatement should include inquiries regarding fraud risks.

52. The auditor should use his or her knowledge of the company and its environment as well as information from other risk assessment procedures to determine the nature of those inquiries.

^{24/} Paragraphs 20-23 of Proposed Auditing Standard, *Evaluating Audit Results*, establish further requirements for evaluating whether misstatements might be indicative of fraud and determining the necessary procedures to be performed in those situations.

Inquiries Regarding Fraud Risks

53. The auditor's inquiries regarding fraud risks should include the following:
- a. Inquiries of management regarding:
 - (1) Whether management has knowledge of fraud, alleged fraud or suspected fraud affecting the company;
 - (2) Management's process for identifying and responding to the risks of fraud in the company, including any specific fraud risks the company has identified or account balances or disclosures for which a fraud risk is likely to exist, and the nature, extent, and frequency of management's fraud risk assessment process;
 - (3) Controls that the company has established to address fraud risks the company has identified, or that otherwise help to prevent and detect fraud, including how management monitors those controls;
 - (4) For a company with multiple locations (a) the nature and extent of monitoring of operating locations or business segments and (b) whether there are particular operating locations or business segments for which a risk of fraud might be more likely to exist;
 - (5) Whether and how management communicates to employees its views on business practices and ethical behavior;
 - (6) Whether management has received tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, management's responses to such tips and complaints; and
 - (7) Whether management has reported to the audit committee on how the company's internal control serves to prevent and detect material misstatements due to fraud.

- b. Inquiries of the audit committee, or equivalent, or its chair regarding:
- (1) The audit committee's views about the risks of fraud;
 - (2) Whether the audit committee has knowledge of fraud, alleged fraud, or suspected fraud affecting the company;
 - (3) Whether the audit committee is aware of tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program) and, if so, the audit committee's responses to such tips and complaints; and
 - (4) How the audit committee exercises oversight of the company's assessment of the risks of fraud and the establishment of mitigating controls.
- c. If the company has an internal audit function, inquiries of appropriate internal audit personnel regarding:
- (1) The internal auditors' views about the risks of fraud;
 - (2) Whether the internal auditors have knowledge of fraud, alleged fraud, or suspected fraud affecting the company;
 - (3) Whether internal auditors have performed procedures to identify or detect fraud during the year, and whether management has satisfactorily responded to the findings resulting from those procedures; and
 - (4) Whether the internal auditor is aware of instances of management override of controls and the nature and circumstances of such overrides.

54. In addition to the inquiries outlined in the preceding paragraph, the auditor should inquire of others within the company about their views regarding fraud risks, including, in particular, whether they have knowledge of fraud, alleged fraud, or suspected fraud. The auditor should identify other individuals within the company to whom inquiries should be directed by considering whether others in the company might have additional knowledge about fraud, alleged or suspected

fraud or be able to corroborate risks of fraud identified in discussions with management or the audit committee. Examples of others within the company to whom inquiries might be directed include:

- Employees with varying levels of authority within the entity, including, for example, entity personnel with whom the auditor comes into contact during the course of the audit (a) in obtaining an understanding of internal control, (b) in observing inventory or performing cutoff procedures, or (c) in obtaining explanations for significant differences identified when performing analytical procedures
- Operating personnel not directly involved in the financial reporting process
- Employees involved in initiating, recording, or processing complex or unusual transactions, e.g., a sales transaction with multiple elements or a significant related party transaction
- In-house legal counsel

55. When evaluating management's responses to inquiries about fraud risks, the auditor should take into account that management is often in the best position to commit fraud in determining when it is necessary to corroborate management's responses. Also, the auditor should obtain evidence to address inconsistencies in responses to the inquiries.

Identifying and Assessing the Risks of Material Misstatement

56. 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:

- a. Identify risks of misstatement due to error or fraud using information obtained from the risk assessment procedures (as discussed in paragraphs 4-55) and considering the characteristics of the accounts and disclosures in the financial statements.

Note: Factors relevant to identifying fraud risks are discussed in paragraphs 67-70.

- b. Evaluate whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions.
- c. Evaluate the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected.

Note: In identifying and assessing risks at the assertion level, the auditor should evaluate how risks at the financial statement level could affect risks of misstatement at the assertion level.

- 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.

Note: In assessing the likelihood and magnitude of potential misstatement, the auditor may take into account the planned degree of reliance on controls selected to test.^{25/}

- e. Identify significant accounts and disclosures^{26/} and their relevant assertions^{27/} (paragraphs 57-61).

^{25/} Paragraphs 16-34 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

^{26/} Paragraph A10 of Auditing Standard No. 5 states, "An account or disclosure is a significant account or disclosure if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls."

^{27/} Paragraph A9 of Auditing Standard No. 5 states, "A relevant assertion is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion

Note: 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.

Note: Paragraphs 62-63 discuss the auditor's responsibilities for understanding likely sources of misstatement in relation to relevant assertions.

- f. Determine whether any of the identified and assessed risks of material misstatement are significant risks (paragraph 71).

Note: The determination of whether a risk of material misstatement is a **significant risk** is based on inherent risk, without regard to the effect of controls.

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

57. To identify significant accounts and disclosures and their relevant assertions in accordance with paragraph 56e, 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;

is a relevant assertion is based on inherent risk, without regard to the effect of controls."

- 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.

58. 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.

59. 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.

Note: 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.^{28/}

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

^{28/} This is because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high (see paragraphs 12-14 of Proposed Auditing Standard, *Evaluating Auditing Results*, for further discussion about undetected misstatement) or as a means of introducing unpredictability in the procedures performed (see paragraph 61 of Auditing Standard No. 5 and paragraph 5 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, for further discussion about unpredictability of auditing procedures).

61. 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.

Understanding Likely Sources of Misstatement

62. To further understand the likely sources of potential misstatements,^{29/} the auditor should achieve the following objectives:

- Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded;
- Verify that the auditor has identified the points within the company's processes at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material;
- Identify the controls that management has implemented to address these potential misstatements; and
- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.

63. The auditor also should understand how IT affects the company's flow of transactions. (See Appendix B.)

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

64. *Performing Walkthroughs.* Performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 62. In performing a

^{29/} In an integrated audit, the procedures to achieve the objectives in this paragraph also apply to the selection of controls to test in the audit of internal control over financial reporting. See paragraph 34 of Auditing Standard No. 5.

walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and information technology that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

65. In performing a walkthrough, at the points at which important processing procedures occur, the auditor questions the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions, combined with the other walkthrough procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough allow the auditor to gain an understanding of the different types of significant transactions handled by the process.

Factors Relevant to Identifying Fraud Risks

66. The auditor should evaluate whether the information gathered from the risk assessment procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks. Fraud risk factors are events or conditions that indicate (1) an incentive or pressure to perpetrate fraud, (2) an opportunity to carry out the fraud, or (3) an attitude or rationalization that justifies the fraudulent action. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances in which fraud exists. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are listed in AU sec. 316.85. These illustrative risk factors are classified based on the three conditions discussed in the preceding paragraph, which generally are present when fraud exists.

Note: The factors listed in AU sec. 316.85 cover a broad range of situations and are only examples. Accordingly, the auditor might identify additional or different fraud risk factors.

67. The auditor should not assume that all of the conditions discussed in paragraph 66 must be observed or evident to conclude that a fraud risk exists. The auditor might conclude that a fraud risk exists even when only one of these three conditions is present.

68. *Consideration of the Risk of Omitted or Incomplete Disclosures.* The auditor's evaluation of fraud risk factors in accordance with paragraph 66 should include evaluation of how fraud could be perpetrated or concealed through omitting or presenting incomplete disclosures.

69. *Presumption of Fraud Risk Involving Improper Revenue Recognition.* The auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.

70. *Consideration of the Risk of Management Override of Controls.* The auditor's identification of fraud risks should include the risk of management override of controls.

Note: Controls over management override are important to effective internal control over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override.

Factors Relevant to Identifying Significant Risks

71. Factors that should be evaluated in determining which risks are significant risks include:

- a. Whether the risk is a fraud risk;

Note: A fraud risk is a significant risk.

- b. Whether the risk is related to recent significant economic, accounting, or other developments;
- c. The complexity of transactions;
- d. Whether the risk involves significant transactions with related parties;

- e. The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- f. Whether the risk involves significant transactions that are outside the normal course of business for the company, or that otherwise appear to be unusual due to their timing, size or nature.

Further Consideration of Controls

72. When the auditor has determined that a significant risk, including a fraud risk, exists, the auditor should evaluate the design of the company's controls that are intended to address fraud risks and other significant risks and determine whether those controls have been implemented, if the auditor has not already done so when obtaining an understanding of internal control over financial reporting, as described in paragraphs 18-35 of this standard.

Note: Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, provides direction on the auditor's response to fraud risks and other significant risks.

73. Controls that address fraud risks include (a) specific controls designed to mitigate specific risks of fraud, e.g., controls to address risks of intentional misstatement of specific accounts and (b) controls designed to prevent, deter, and detect fraud, e.g., controls to promote a culture of honesty and ethical behavior.^{30/} Such controls also include those that address the risk of management override of other controls.

Revision of Risk Assessment

74. The auditor's assessment of the risks of material misstatement, including fraud risks, should be ongoing throughout the audit. When the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor

^{30/} AU sec. 316.88 and paragraph 14 of Auditing Standard No. 5 present examples of controls that address fraud risks.

should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.^{31/}

^{31/} See also Paragraph 46 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

APPENDIX A – Definitions

- A1. For purposes of this standard, the terms listed below are defined as follows:
- A2. Business risks – Risks that result from significant conditions, events, circumstances, actions or inactions that could adversely affect a company's ability to achieve its objectives and execute its strategies. Business risks also might result from setting inappropriate objectives and strategies or from change or complexity in the company's operations or management.
- A3. Company's objectives – The overall plans for the company as established by management or the board of directors. Strategies are the approaches by which management intends to achieve its objectives.
- A4. Risk assessment procedures – The procedures performed by the auditor to obtain information for identifying and assessing the risks of material misstatement in the financial statements.^{32/}
- A5. Significant risk – A risk of material misstatement that requires special audit consideration.

^{32/} Risk assessment procedures by themselves do not provide sufficient appropriate evidence on which to base an audit opinion.

APPENDIX B – Consideration of Manual and Automated Systems and Controls

B1. While obtaining an understanding of the company's information system related to financial reporting, the auditor should obtain an understanding of how the company uses information technology ("IT") and how IT affects the financial statements. The auditor also should obtain an understanding of the extent of manual controls and automated controls used by the company, including the IT general controls that are important to the effective operation of the automated controls. That information should be taken into account in assessing the risks of material misstatement.

Note: Paragraphs 16-18 of Proposed Auditing Standard, *Audit Planning and Supervision*, establish requirements and provides direction regarding (1) the determination as to whether specialized IT knowledge or skills are needed on an audit and (2) the use of a person with specialized IT knowledge and skills employed or engaged by the auditor's firm.

B2. Controls in a manual system might include procedures such as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items.

B3. Alternatively, a company might use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format would replace paper documents. When IT is used to initiate, record, process, and report transactions, the IT systems and programs may include controls related to the relevant assertions of significant accounts and disclosures or may be critical to the effective functioning of manual controls that depend on IT.

B4. The auditor should obtain an understanding of specific risks to a company's internal control over financial reporting resulting from IT. Examples of such risks include:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both
- Unauthorized access to data that might result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions or inaccurate recording of

transactions. Particular risks might arise when multiple users access a common database

- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby breaking down segregation-of-duties
- Unauthorized changes to data in master files
- Unauthorized changes to systems or programs
- Failure to make necessary changes to systems or programs
- Inappropriate manual intervention
- Potential loss of data or inability to access data as required

B5. In obtaining an understanding of the company's control activities, the auditor should obtain an understanding of how the company has responded to risks arising from IT.

B6. When a company uses manual elements in internal control systems, the auditor should design procedures to test the consistency in the application of manual controls.

Proposed Auditing Standard

The Auditor's Responses to the Risks of Material Misstatement

Introduction

1. This standard establishes requirements and provides direction regarding designing and implementing appropriate responses to the risks of material misstatement.

Objective

2. The objective of the auditor is to address the risks of material misstatement through appropriate overall audit responses and audit procedures.

Responding to the Risks of Material Misstatement

3. To meet the objective of this standard, the auditor must design and implement responses that address the risks of material misstatement that are identified and assessed in accordance with Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

4. This standard discusses the following types of audit responses:
- a. Responses that have an overall effect on how the audit is conducted ("overall responses"), as described in paragraphs 5-7.
 - b. Responses involving the nature, timing, and extent of the audit procedures to be performed, as described in paragraphs 8-46.

Overall Responses

5. The auditor should design and implement overall responses to address the assessed risks of material misstatement as follows:
- a. *Making appropriate assignments of significant engagement responsibilities.* The knowledge, skill, and ability of engagement team members with significant engagement responsibilities should be commensurate with the assessed risks of material misstatement.

- b. *Providing a level of supervision that is appropriate for the circumstances, including, in particular, the assessed risks of material misstatement. (See paragraphs 21-24 of Proposed Auditing Standard, *Audit Planning and Supervision*.)*
- 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 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; (b) varying the timing or location of the audit procedures; (c) selecting items for testing that have lower amounts or are otherwise outside customary selection parameters; and (d) performing audit procedures on an unannounced basis.*
- d. *Evaluating the company's selection and application of significant accounting principles. The auditor should evaluate whether the company's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions^{1/} are indicative of bias that could lead to material misstatement of the financial statements.*

Note: Paragraph .11 of AU sec. 380, *Communication With Audit Committees*, discusses auditor judgments about the quality of a company's accounting principles.

6. The auditor also should evaluate whether it is necessary to make pervasive changes to the nature, timing, or extent of audit procedures to adequately address the assessed risks of material misstatement. Examples of such pervasive changes include performing substantive procedures at the period

^{1/} Paragraphs 12-13 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, discuss the auditor's responsibilities regarding obtaining an understanding of the company's selection and application of accounting principles.

end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.

7. Due professional care requires the auditor to exercise professional skepticism.^{2/} Accordingly, the auditor's responses to the assessed risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit evidence.^{3/} Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence. Examples of the application of professional skepticism in response to the assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters, such as through third-party confirmation, use of a specialist engaged or employed by the auditor, or examination of documentation from independent sources.

Responses Involving the Nature, Timing, and Extent of Audit Procedures

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

9. In designing the audit procedures to be performed, the auditor should:
- a. Obtain more persuasive audit evidence the higher the auditor's assessment of risk;

^{2/} Paragraphs .07-.09 of AU sec. 230, *Due Professional Care in the Performance of Work*.

^{3/} Paragraph .13 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

- b. Take into account the types of potential misstatements that could result from the identified risks and the likelihood and magnitude of potential misstatement;^{4/}
 - c. In an integrated audit, design the testing of controls to accomplish the objectives of both audits simultaneously –
 - (1) To obtain sufficient evidence to support the auditor's control risk^{5/} assessments for purposes of the audit of financial statements;^{6/} and
 - (2) To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year end.
10. The audit procedures performed in response to the assessed risks of material misstatement can be classified into two categories – tests of controls and substantive procedures.^{7/} Paragraphs 16-35 of this standard discuss tests of controls, and paragraphs 36-46 discuss substantive procedures.

Note: Paragraphs 16-17 discuss when tests of controls are necessary in a financial statement audit. Ordinarily, tests of controls are performed for relevant assertions for which the auditor chooses to rely on controls to modify his or her substantive procedures.

^{4/} For example, potential misstatements regarding disclosures include omission of required disclosures or presentation of incorrect or incomplete disclosures.

^{5/} See paragraph 7.b. of Proposed Auditing Standard, *Audit Risk*, for a definition of control risk.

^{6/} For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

^{7/} Substantive procedures consist of (a) tests of details of accounts and disclosures and (b) substantive analytical procedures.

Responses to Significant Risks

11. For significant risks, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed risks.

Note: Paragraph 71 of Proposed Auditing Standard, *Identifying and Assessing the Risks of Material Misstatement*, discusses identification of significant risks. Paragraphs 12-15 of this standard discuss the auditor's responses to assessed fraud risks.

Responses to Fraud Risks

12. The audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected.

Note: If the auditor identifies deficiencies in controls that are intended to address assessed fraud risks, the auditor should take into account those deficiencies when developing his or her response to those fraud risks.

Note: Paragraphs 14-15 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, establish requirements and provide direction regarding addressing assessed fraud risks in the audit of internal control over financial reporting.

13. *Addressing Fraud Risks in the Audit of Financial Statements*. In the audit of financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks. The auditor also may perform tests of controls intended to address the assessed fraud risks that are selected for testing in accordance with paragraphs 16-17 of this standard.

14. The following are examples of ways in which planned audit procedures may be modified to address assessed fraud risks:

- a. Changing the *nature* of audit procedures to obtain evidence that is more reliable or to obtain additional corroborative information.

- b. Changing the *timing* of audit procedures to be closer to the end of the period or to the points during the period in which fraudulent transactions are more likely to occur.
- c. Changing the *extent* of the procedures applied to obtain more evidence, e.g., by increasing sample sizes or applying computer-assisted audit techniques to all of the items in an account.

Note: Paragraphs .54-.67 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, provide further examples of and additional direction on responses to assessed fraud risks relating to fraudulent financial reporting (e.g., revenue recognition, inventory quantities, and management estimates) and misappropriation of assets in the audit of financial statements.

15. Also, AU sec. 316 indicates that the auditor should perform audit procedures to specifically address the risk of management override of controls including:

- a. Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud (AU secs. 316.58-.62),
- b. Reviewing accounting estimates for biases that could result in material misstatement due to fraud (AU secs. 316.63-.65), and
- c. Evaluating the business rationale for significant unusual transactions (AU secs. 316.66-.67).

Testing Controls

Testing Controls in an Audit of Financial Statements

16. *Controls to be Tested.* If the auditor plans to assess control risk at less than the maximum by relying on controls,^{8/} and the nature, timing, and extent of

^{8/} Reliance on controls, when appropriate, allows the auditor to assess control risk at less than the maximum, which results in a lower assessed

planned substantive procedures are based on that lower assessment, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire **period of reliance**.^{9/} However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

17. Also, tests of controls must be performed in the audit of financial statements for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence and when necessary to support the auditor's reliance on the completeness and accuracy of financial information used in performing other audit procedures.^{10/}

Note: When a significant amount of information supporting one or more relevant assertions is electronically initiated, recorded, processed, or reported, it might be impossible to design effective substantive tests that, by themselves, would provide sufficient appropriate evidence regarding the assertions. For such assertions, significant audit evidence may be available only in electronic form. In such cases, the sufficiency and appropriateness of the audit evidence usually depend on the effectiveness of controls over their accuracy and completeness. Furthermore, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed, or reported only in electronic form and appropriate controls are not operating effectively.

18. *Evidence about the Effectiveness of Controls in the Audit of Financial Statements.* In designing and performing tests of controls for the audit of financial statements, the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The auditor should obtain more persuasive audit

risk of material misstatement. In turn, this might allow the auditor to modify the nature, timing, and extent of planned substantive procedures.

^{9/} Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

^{10/} See paragraph 10 of Proposed Auditing Standard, *Audit Evidence*, and paragraph .16 of AU sec. 329, *Substantive Analytical Procedures*.

evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. The auditor also should obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.

Testing Design Effectiveness

19. The auditor should test the design effectiveness of the controls selected for testing by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect error or fraud that could result in material misstatements in the financial statements.

Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.

20. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.^{11/}

Testing Operating Effectiveness

21. The auditor should test the operating effectiveness of a control selected for testing by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

^{11/} Paragraphs 64-65 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatements*, provide direction on performing a walkthrough.

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.

Obtaining Evidence from Tests of Controls

23. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing might provide sufficient evidence in relation to the degree of reliance in an audit of financial statements.

Note: To obtain evidence about whether a control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures.

Nature of Tests of Controls

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.

25. The nature of the tests of controls that will provide appropriate evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

Note: A smaller, less complex company or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, or re-performance of certain controls,

might provide sufficient evidence about whether the control is effective.

Extent of Tests of Controls

26. The more extensively a control is tested, the greater the evidence obtained from that test.

27. Matters that could affect the necessary extent of testing of a control in relation to the degree of reliance on a control include the following:

- The frequency of the performance of the control by the company during the audit period
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control
- The expected rate of deviation from a control
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control
- The extent to which audit evidence is obtained from tests of other controls related to the assertion
- The nature of the control, including, in particular, whether it is a manual control or an automated control
- For an automated control, the effectiveness of relevant general controls

Note: AU sec. 350, *Audit Sampling*, provides direction on the use of sampling in tests of controls.

Timing of Tests of Controls

28. The timing of tests of controls relates to when the evidence about the operating effectiveness of the controls is obtained and the period of time to which it applies. Paragraph 16 indicates that the auditor must obtain evidence that the

controls selected for testing are designed effectively and operated effectively during the entire period of reliance.

29. *Using Audit Evidence Obtained during an Interim Period.* When the auditor obtains evidence about the operating effectiveness of controls as of or through an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.

30. 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:

- The inherent risk associated with the related account(s) or assertion(s);
- The specific control tested prior to year-end, including the nature of the control and the risk that the control is no longer effective during the remaining period, and the results of the tests of the control;
- The planned degree of reliance on the control;
- The sufficiency of the evidence of effectiveness obtained at an interim date;
- The length of the remaining period; and
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

31. *Using Audit Evidence Obtained in Past Audits.* For audits of financial statements, the auditor should obtain evidence during the current year audit about the design and operating effectiveness of controls upon which the auditor relies. When controls have been tested in past audits, the auditor should take into account the following factors to determine the evidence needed during the current year audit to support the auditor's control risk assessments:

- The nature and materiality of misstatements that the control is intended to prevent or detect

- The inherent risk associated with the related account(s) or assertion(s)
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness
- Whether the account has a history of errors
- The effectiveness of entity-level controls, especially controls that monitor other controls
- The nature of the controls and the frequency with which they operate
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls)
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance
- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective)^{12/}
- The complexity of the control and the significance of the judgments that must be made in connection with its operation
- The planned degree of reliance on the control

^{12/} The auditor also may use a benchmarking strategy, when appropriate, for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B28 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*.

- The nature, timing, and extent of procedures performed in past audits
- The results of the previous years' testing of the control
- Whether there have been changes in the control or the process in which it operates since the previous audit
- For integrated audits, the evidence regarding the effectiveness of the controls obtained during the audit of internal control

Assessing Control Risk

32. The auditor should assess control risk for relevant assertions by evaluating the evidence obtained from all sources, including the auditor's testing of controls for the audit of internal control and the audit of financial statements, misstatements detected during the financial statement audit, and any identified control deficiencies.

33. Control risk should be assessed at the maximum level for relevant assertions for which controls necessary to sufficiently address the assessed risk of material misstatement in those assertions are missing or ineffective or when the auditor has not obtained sufficient appropriate evidence about the effectiveness of those controls.

34. When deficiencies affecting the controls upon which the auditor intends to rely are detected, the auditor should evaluate the severity of the deficiencies and the effect on the auditor's control risk assessments. If the auditor plans to rely on controls relating to an assertion, but the controls that the auditor tests are ineffective because of control deficiencies, the auditor should:

- a. Perform tests of other controls related to the same assertion as the ineffective controls; or
- b. Revise the control risk assessment and modify the planned substantive procedures as necessary in light of the increased assessment of risk.

Note: Auditing Standard No. 5 provides direction on evaluating the severity of a control deficiency and communicating identified control deficiencies to management and the audit committee in an integrated audit. AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*, provides direction on communicating significant deficiencies and material weaknesses in an audit of financial statements only.

Testing Controls in an Audit of Internal Control

35. Auditing Standard No. 5 states that the objective of the tests of controls in an audit of internal control is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a point in time and taken as a whole.^{13/} Auditing Standard No. 5 establishes requirements regarding the selection of controls to be tested and the necessary nature, timing, and extent of tests of controls in an audit of internal control over financial reporting.

Substantive Procedures

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

37. As the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases. The evidence provided by the auditor's substantive procedures depends upon the mix of the nature, timing, and extent of those procedures. Further, for an individual assertion, different combinations of the nature, timing, and extent of testing might provide sufficient appropriate evidence to respond to the assessed risk of material misstatement.

^{13/} Paragraph B1 of Auditing Standard No. 5.

38. Internal control over financial reporting has inherent limitations,^{14/} which, in turn, can affect the evidence that is needed from substantive procedures. For example, more evidence from substantive procedures ordinarily is needed for relevant assertions that have a higher susceptibility to management override or to lapses in judgment or breakdowns resulting from human failures.^{15/}

Nature of Substantive Procedures

39. Substantive procedures generally provide persuasive evidence when they are designed and performed to obtain evidence that is relevant and reliable. Also, some types of substantive procedures, by their nature, produce more persuasive evidence than others. Inquiry alone does not provide sufficient appropriate evidence to support a conclusion about a relevant assertion.

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

40. Taking into account the types of potential misstatements in the relevant assertions that could result from the identified risks, as required by paragraph 9(b), can help the auditor determine the types and combination of substantive audit procedures that are necessary to detect material misstatements in the respective assertions.

41. *Substantive Procedures Related to the Period-end Financial Reporting Process.* The auditor's substantive procedures must include the following audit procedures related to the period-end financial reporting process:

- a. Reconciling the financial statements with the underlying accounting records; and
- b. Examining material adjustments made during the course of preparing the financial statements.

^{14/} Paragraph A5 of Auditing Standard No. 5.

^{15/} See, e.g., paragraph .14 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures*.

Note: AU secs. 316.58-62 provide direction on examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.

Extent of Substantive Procedures

42. The more extensively a substantive procedure is performed, the greater the evidence obtained from the procedure. The necessary extent of a substantive audit procedure depends on the materiality of the account or disclosure, the assessed risk of material misstatement, and the necessary degree of assurance from the procedure. 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.

Timing of Substantive Procedures

43. Performing certain substantive procedures at interim dates may permit early consideration of matters affecting the year-end financial statements, e.g., testing material transactions involving higher risks of misstatement. However, performing substantive procedures at an interim date without performing procedures at a later date increases the risk that a material misstatement could exist in the year-end financial statements that would not be detected by the auditor. This risk increases as the period between the interim date and year end increases.

44. In determining whether it is appropriate to perform substantive procedures at an interim date, the auditor should take into account the following:

- a. The assessed risk of material misstatement, including:
 - (1) The auditor's assessment of control risk (as discussed in paragraphs 32-34)
 - (2) The existence of conditions or circumstances, if any, that create incentives or pressures on management to misstate the financial statements between the interim test date and the end of the period covered by the financial statements
- b. The nature of the substantive procedures

- c. The nature of the account or disclosure and relevant assertion
- d. The ability of the auditor to perform the necessary audit procedures to cover the remaining period

45. When substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. Such procedures should include (a) comparing relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual and investigating such amounts, and (b) performing audit procedures to test the remaining period.

46. If the auditor obtains evidence that contradicts the evidence on which the original risk assessments were based, including evidence of misstatements that he or she did not expect, the auditor should re-evaluate the related risk assessments and modify the planned nature, timing, or extent of substantive procedures covering the remaining period as necessary. Examples of such modifications include extending or repeating at the period end the procedures performed at the interim date.

Dual-purpose Tests

47. In some situations, the auditor might perform a substantive test of a transaction concurrently with a test of a control relevant to that transaction (a "**dual-purpose test**"). In those situations, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested.^{16/}

^{16/} Paragraph .44 of AU sec. 350, *Audit Sampling*, discusses applying audit sampling in dual-purpose tests.

APPENDIX A– Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Dual-purpose test – Substantive test of a transaction and a test of a control relevant to that transaction that are performed concurrently, e.g., a substantive test of sales transactions performed concurrently with a test of controls over those transactions.

A3. Period of reliance – The period being covered by the company's financial statements, or the portion of that period, for which the auditor plans to rely on controls in order to modify the nature, timing, and extent of planned substantive procedures.

Proposed Auditing Standard

Evaluating Audit Results

Introduction

1. This standard establishes requirements and provides direction regarding the auditor's evaluation of audit results and determination of whether he or she has obtained sufficient appropriate audit evidence.

Objective

2. The objective of the auditor is to evaluate the results of the audit to determine whether the audit evidence obtained is sufficient and appropriate to support the opinion to be expressed in the auditor's report.

Evaluating the Results of the Audit of Financial Statements

3. In forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, the auditor should take into account all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.

4. In the audit of the financial statements,^{1/} the auditor's evaluation of audit results should include evaluation of the following:

- a. The results of analytical procedures performed in the overall review of the financial statements ("overall review");
- b. **Misstatements** accumulated during the audit, including, in particular, **uncorrected misstatements**;^{2/}

^{1/} For purposes of this standard, the term "audit of the financial statements" refers to the financial statement portion of the integrated audit and to the audit of the financial statements only.

^{2/} Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

- c. The qualitative aspects of the company's accounting practices;
- d. Conditions identified during the audit that relate to the assessment of the risk of material misstatement due to fraud ("fraud risk");
- e. The presentation of the financial statements, including disclosures; and
- f. The sufficiency and appropriateness of the audit evidence obtained.

Performing Analytical Procedures in the Overall Review

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.
6. As part of the overall review, the auditor should evaluate whether –
- a. The evidence gathered in response to unusual or unexpected transactions, events, amounts or relationships previously identified during the audit is sufficient, and
 - b. Unusual or unexpected transactions, events, amounts or relationships^{3/} indicate risks of material misstatement that were not identified previously, including, in particular, fraud risks.

Note: If the auditor discovers a previously unidentified risk of material misstatement or concludes that the evidence gathered is not adequate, he or she should modify his or her audit procedures or perform additional procedures as necessary in accordance with paragraph 36.

^{3/} Paragraph 45 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

7. The nature and extent of the analytical procedures performed during the overall review may be similar to the analytical procedures performed as risk assessment procedures. These procedures should include analytical procedures relating to revenue through the end of the reporting period.^{4/}

8. The auditor should obtain corroboration for management's explanations regarding significant unusual or unexpected transactions, events, amounts or relationships. If management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures as necessary to address the matter.

9. *Evaluating Whether Analytical Procedures Indicate a Previously Unrecognized Fraud Risk.* Whether an unusual or unexpected transaction, event, amount, or relationship indicates a fraud risk as discussed in paragraph 6b depends on the relevant facts and circumstances, including the nature of the account or relationship among the data used in the analytical procedures. For example, certain unusual or unexpected transactions, events, amounts or relationships could indicate a fraud risk if a component of the relationship involves accounts and disclosures that management has incentives or pressures to manipulate, e.g., significant unusual or unexpected relationships involving year-end revenue and income.

Accumulating and Evaluating Identified Misstatements

10. *Accumulating Identified Misstatements.* The auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial.^{5/}

^{4/} Paragraphs 43-45 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, provide direction on performing analytical procedures relating to revenue as part of the risk assessment procedures.

^{5/} Clearly trivial is not another expression for not material. Matters that are clearly trivial will be of a smaller order of magnitude than materiality determined in accordance with Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*, and will be inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be trivial.

11. The auditor may designate an amount below which misstatements are clearly trivial and do not need to be accumulated. In such cases, the amount should be set so that any misstatements below that amount would not be material to the financial statements, individually or in combination with other misstatements, considering the possibility of undetected misstatement.

12. 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, and projected misstatements from substantive procedures that involve audit sampling, as determined in accordance with paragraph .26 of AU sec. 350, *Audit Sampling*.

13. *Misstatements Relating to Accounting Estimates.* 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, he or she should treat the difference between that estimate and a reasonable estimate determined in conformity with the applicable accounting principles as a misstatement. If a range of reasonable estimates is supported by sufficient appropriate audit evidence, and the recorded estimate is outside of the range of reasonable estimates, the auditor should treat the difference between the recorded accounting estimate and the closest reasonable estimate as a misstatement.^{6/}

Note: Paragraph 27 discusses evaluating accounting estimates for bias.

14. *Considerations as the Audit Progresses.* The auditor should determine whether the overall audit strategy and audit plan need to be revised if:

- a. The nature of accumulated misstatements and the circumstances of their occurrence indicate that other misstatements might exist

^{6/} If an accounting estimate is determined in conformity with the applicable accounting principles and the amount of the estimate is reasonable, a difference between an estimated amount best supported by the audit evidence and the recorded amount of the accounting estimate ordinarily would not be considered to be a misstatement. See paragraph 27.

that, in combination with accumulated misstatements, could be material; or

- b. The aggregate of misstatements accumulated during the audit approaches the materiality level used in planning and performing the audit.^{7/}

Note: When the aggregate of accumulated misstatements approaches the materiality level used in planning and performing the audit, there likely will be greater than an appropriately low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit that remain uncorrected, could be material to the financial statements. If the auditor's assessment of this risk is unacceptably high, he or she should perform additional audit procedures or determine that management has adjusted the financial statements so that the risk that financial statements are materially misstated has been reduced to an appropriately low level.

15. The auditor should communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them.

16. If management has examined an account or a disclosure in response to misstatements detected by the auditor and has made corrections to the account or disclosure, the auditor should evaluate management's work to determine whether the corrections have been appropriately recorded and whether uncorrected misstatements remain.

17. *Evaluation of the Effect of Uncorrected Misstatements.* The auditor should evaluate whether the 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 accounts and disclosures

^{7/} Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit.*

and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.^{8/}

Note: 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^{9/} that it could lead to a material contingent liability or a material loss of revenue.^{10/} Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

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.

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.

19. The auditor cannot assume that an instance of error or fraud is an isolated occurrence. Therefore, the auditor should evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement. This evaluation is important in determining whether the

^{8/} If the financial statements contain material misstatements, AU sec. 508, *Reports on Audited Financial Statements*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 provides direction when the financial statements are materially affected by a departure from the applicable financial reporting framework.

^{9/} There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

^{10/} AU sec. 317, *Illegal Acts by Clients*.

risk assessments remain appropriate, as discussed in paragraph 36 of this standard.

20. *Evaluating Whether Misstatements Might Be Indicative of Fraud.* The auditor should evaluate whether identified misstatements^{11/} might be indicative of fraud and, in turn, how they affect the auditor's evaluation of materiality and the related audit responses. As indicated in paragraph .05 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, fraud is an intentional act that results in material misstatement of the financial statements.

21. If the auditor believes that a misstatement is or might be intentional and if the effect on the financial statements could be material or cannot be readily determined, the auditor should attempt to obtain additional audit evidence to determine whether fraud has occurred or is likely to have occurred and, if so, its effect on the financial statements and the auditor's report thereon.

22. Also, for any misstatements that the auditor believes are or might be intentional, the auditor should assess the implications for the integrity of management or employees and the possible effect on other aspects of the audit. If the misstatement involves higher-level management, it might be indicative of a more pervasive problem, such as an issue with the integrity of management, even if the amount of the misstatement is small. In such circumstances, the auditor should reevaluate the assessment of fraud risk and the effect of that assessment on (a) the nature, timing, and extent of the necessary tests of accounts or disclosures, and (b) the assessment of the effectiveness of controls. The auditor also should evaluate whether the circumstances or conditions indicate possible collusion involving employees, management, or external parties and, if so, the effect of the collusion on the reliability of evidence obtained.

23. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, he or she also must determine his or her responsibilities under AU secs. 316.79-82A, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1.

^{11/} Misstatements include omission or incomplete presentation of disclosures.

Evaluating the Qualitative Aspects of the Company's Accounting Practices

24. 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.

25. The following are examples of forms of management bias:

- a. The selective correction of misstatements brought to management's attention during the audit (e.g., correcting misstatements with the effect of increasing reported earnings but not correcting misstatements that have the effect of decreasing reported earnings).

Note: To assess the potential effect of selective correction of misstatements, the auditor should obtain an understanding of the reasons why management decided not to correct misstatements communicated by the auditor in accordance with paragraph 15.

- b. The identification by management of additional adjusting entries that offset other misstatements identified by the auditor. If such misstatements are identified, the auditor should perform procedures to determine why the misstatement was not identified previously and assess the implications on the integrity of management and the auditor's risk assessments, including fraud risk assessments, and should perform additional procedures as necessary to address the risk of further undetected misstatements.
- c. Bias in the selection and application of accounting principles.^{12/}
- d. Bias in accounting estimates.^{13/}

26. If the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, he or she should evaluate

^{12/} Paragraph 5.d. of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

^{13/} Paragraph 27.

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 the risks of material misstatement due to fraud, and the related audit responses remain appropriate.

27. *Evaluating Bias in Accounting Estimates.* The auditor should evaluate whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the company's management. If each accounting estimate included in the financial statements was individually reasonable but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase income, the auditor should evaluate whether this indicates potential management bias in the estimates. Bias can also result from the cumulative effect of changes in multiple accounting estimates.

Note: AU secs. 316.64-.65 provide additional direction regarding performing a retrospective review of accounting estimates and evaluating the potential for fraud risks.

Evaluating Conditions Relating to the Assessment of Fraud Risks

28. When evaluating the results of the audit, the auditor should evaluate whether the accumulated results of auditing procedures^{14/} and other observations affect the assessment of the fraud risks made throughout the audit and the need to modify the audit procedures to respond to those risks. (See Appendix C.)

29. As part of this evaluation, the engagement partner should ascertain whether there has been appropriate communication with the other engagement team members throughout the audit regarding information or conditions indicative of fraud risks.^{15/}

^{14/} Such auditing procedures include, but are not limited to, procedures in the overall review (paragraph 9), the evaluation of identified misstatements (paragraphs 20-23), and the evaluation of the qualitative aspects of the company's accounting practices (paragraphs 24-27).

^{15/} To accomplish this communication, the engagement partner might arrange another discussion among the audit team members about fraud risks.

Evaluating the Presentation of the Financial Statements, Including the Disclosures

30. The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.^{16/}

Note: AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, establish requirements for evaluating the presentation of the financial statements. Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, provides direction on evaluating the consistency of the accounting principles used in financial statements.

31. As part of the evaluation of the presentation of the financial statements, the auditor should evaluate whether the financial statements contain the required disclosures. Evaluation of disclosures 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.

Note: According to AU sec. 508, *Reports on Audited Financial Statements*, if the financial statements, including 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.^{17/}

(See paragraphs 47-48 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.)

^{16/} The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

^{17/} See AU secs. 508.41-.44.

Evaluating the Sufficiency and Appropriateness of Audit Evidence

32. Paragraph 3 of Proposed Auditing Standard, *Audit Risk*, states:

To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.

33. As part of evaluating audit results, the auditor must conclude on whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements.

34. Factors that are relevant to the conclusion on whether sufficient appropriate audit evidence has been obtained include the following:

- a. Significance of uncorrected misstatements and the likelihood of their having a material effect, individually or in combination, on the financial statements, considering the possibility of further undetected misstatement. (See paragraphs 14 and 17-19.)
- b. The results of audit procedures performed in the audit of the financial statements, including whether such audit procedures identified specific instances of fraud, as discussed in paragraphs 20-23 and 28-29.
- c. The auditor's risk assessments. (See paragraph 36.)
- d. The results of audit procedures performed in the audit of internal control over financial reporting, if the audit is an integrated audit.
- e. The relevance and reliability of the audit evidence obtained.^{18/}

^{18/} Paragraphs 7-9 of Proposed Auditing Standard, *Audit Evidence*, discuss the relevance and reliability of audit evidence.

35. If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion or has substantial doubt about a relevant assertion, the auditor should attempt to obtain further audit evidence to address the matter. 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, AU sec. 508 indicates that the auditor should express a qualified opinion or a disclaimer of opinion.^{19/}

36. *Evaluating the Appropriateness of Risk Assessments.* As part of the evaluation of whether sufficient appropriate audit evidence has been obtained, the auditor should evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate and whether the audit procedures need to be modified or additional procedures need to be performed as a result of any changes in the risk assessments. For example, the reevaluation of the auditor's risk assessments could result in the identification of relevant assertions or significant risks that were not identified previously and for which the auditor should perform additional audit procedures.

Note: Paragraph 74 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, provides further direction on revising the auditor's risk assessment. Paragraphs 32-34 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, discuss the auditor's responsibilities regarding the assessment of control risk and evaluation of control deficiencies in an audit of financial statements.

Evaluating the Results of the Audit of Internal Control Over Financial Reporting

37. Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, indicates that the auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls for the audit of internal control over financial reporting and the financial statement audit, misstatements detected during the financial statement audit, and any identified control deficiencies. Auditing Standard No. 5

^{19/} AU sec. 508.22-.34, provide direction on audit scope limitations.

describes the auditor's responsibilities regarding evaluating the results of the audit, including evaluating the identified control deficiencies.^{20/}

^{20/} Paragraphs 62-70 of Auditing Standard No. 5 discuss evaluating identified control deficiencies and paragraphs 71-73 of Auditing Standard No. 5 discuss forming an opinion on the effectiveness of internal control over financial reporting.

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. 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.^{21/} 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.^{22/}

A3. Uncorrected misstatements – Misstatements accumulated during the audit that management has not corrected.

^{21/} The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

^{22/} See AU sec. 316.02.

APPENDIX B – Qualitative Factors Related to the Evaluation of the Materiality of Uncorrected Misstatements

B1. Paragraph 17 states –

The auditor should evaluate whether the 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 accounts and disclosures and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.^{23/}

Note: 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^{24/} that it could lead to a material contingent liability or a material loss of revenue.^{25/} Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

B2. Qualitative factors to consider in the auditor's evaluation of the materiality of uncorrected misstatements, if relevant, include the following:

^{23/} If the financial statements contain material misstatements, AU sec. 508, *Reports on Audited Financial Statements*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 provides direction when the financial statements are materially affected by a departure from the applicable financial reporting framework.

^{24/} There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

^{25/} See AU sec. 317, *Illegal Acts by Clients*.

- a. The potential effect of the misstatement on trends, especially trends in profitability.
- b. A misstatement that changes a loss into income or vice versa.
- c. The effect of the misstatement on segment information, for example, the significance of the matter to a particular segment important to the future profitability of the company, the pervasiveness of the matter on the segment information, and the impact of the matter on trends in segment information, all in relation to the financial statements taken as a whole.
- d. The potential effect of the misstatement on the company's compliance with loan covenants, other contractual agreements, and regulatory provisions.
- e. The existence of statutory or regulatory reporting requirements that affect materiality thresholds.
- f. A misstatement that has the effect of increasing management's compensation, for example, by satisfying the requirements for the award of bonuses or other forms of incentive compensation.
- g. The sensitivity of the circumstances surrounding the misstatement, for example, the implications of misstatements involving fraud and possible illegal acts, violations of contractual provisions, and conflicts of interest.
- h. The significance of the financial statement element affected by the misstatement, for example, a misstatement affecting recurring earnings as contrasted to one involving a non-recurring charge or credit, such as an extraordinary item.
- i. The effects of misclassifications, for example, misclassification between operating and non-operating income or recurring and non-recurring income items.
- j. The significance of the misstatement or disclosures relative to known user needs, for example –

- The significance of earnings and earnings per share to public company investors,
 - The magnifying effects of a misstatement on the calculation of purchase price in a transfer of interests (buy/sell agreement).
 - The effect of misstatements of earnings when contrasted with expectations.
- k. The definitive character of the misstatement, for example, the precision of an error that is objectively determinable as contrasted with a misstatement that unavoidably involves a degree of subjectivity through estimation, allocation, or uncertainty.
- l. The motivation of management with respect to the misstatement, for example, (i) an indication of a possible pattern of bias by management when developing and accumulating accounting estimates or (ii) a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process.
- m. The existence of offsetting effects of individually significant but different misstatements.
- n. The likelihood that a misstatement that is currently immaterial may have a material effect in future periods because of a cumulative effect, for example, that builds over several periods.
- o. The cost of making the correction – it may not be cost-beneficial for the client to develop a system to calculate a basis to record the effect of an immaterial misstatement. On the other hand, if management appears to have developed a system to calculate an amount that represents an immaterial misstatement, it may reflect a motivation of management as noted in paragraph B2.l above.
- p. The risk that possible additional undetected misstatements would affect the auditor's evaluation.

APPENDIX C – Matters That Might Affect the Assessment of Fraud Risks

C1. If the following matters are identified during the audit, the auditor should determine whether the assessment of fraud risks remains appropriate or needs to be revised:

- a. Discrepancies in the accounting records, including:
 - (1) Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or company policy
 - (2) Unsupported or unauthorized balances or transactions
 - (3) Last-minute adjustments that significantly affect financial results
 - (4) Evidence of employees' access to systems and records that is inconsistent with the access that is necessary to perform their authorized duties
 - (5) Tips or complaints to the auditor about alleged fraud
- b. Conflicting or missing evidence, including:
 - (1) Missing documents
 - (2) Documents that appear to have been altered^{26/}
 - (3) Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist
 - (4) Significant unexplained items on reconciliations

^{26/} Paragraph 9 of Proposed Auditing Standard, *Audit Evidence*.

- (5) Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures
 - (6) Unusual discrepancies between the company's records and confirmation replies
 - (7) Missing inventory or physical assets of significant magnitude
 - (8) Unavailable or missing electronic evidence, that is inconsistent with the company's record retention practices or policies
 - (9) Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments
 - (10) Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships – for example, receivables growing faster than revenues
 - (11) Large numbers of credit entries and other adjustments made to accounts receivable records
 - (12) Unexplained or inadequately explained differences between the accounts receivable subsidiary ledger and the general ledger control account, or between the customer statement and the accounts receivable subsidiary ledger
 - (13) Missing or non-existent cancelled checks in circumstances in which cancelled checks are ordinarily returned to the company with the bank statement
 - (14) Fewer responses to confirmation requests than anticipated or a greater number of responses than anticipated
- c. Problematic or unusual relationships between the auditor and management, including:

- (1) Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought, including:^{27/}
 - a. Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques
 - b. Denial of access to key IT operations staff and facilities, including security, operations, and systems development
 - (2) Undue time pressures imposed by management to resolve complex or contentious issues
 - (3) Management pressuring engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management
 - (4) Unusual delays by management in providing requested information
 - (5) An unwillingness to add or revise disclosures in the financial statements to make them more complete and transparent
 - (6) An unwillingness to appropriately address significant deficiencies in internal control on a timely basis
- d. Other:
- (1) Objections by management to the auditor meeting privately with the audit committee

^{27/} Denial of access to information might constitute a limitation on the scope of the audit that requires the auditor to qualify or disclaim an opinion. (See Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and AU sec. 508, *Reports on Audited Financial Statements*.)

- (2) Accounting policies that appear inconsistent with industry practices that are widely recognized and prevalent
- (3) Frequent changes in accounting estimates that do not appear to result from changing circumstances
- (4) Tolerating violations of the company's code of conduct

Proposed Auditing Standard

Audit Evidence

Introduction

1. This standard explains what constitutes audit evidence, establishes requirements and provides direction regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence.
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.

Objective

3. The objective of the auditor is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report.

Note: Proposed Auditing Standard, *Evaluating Audit Results*, establishes requirements and provides direction regarding evaluating whether sufficient appropriate evidence has been obtained. Auditing Standard No. 3, *Audit Documentation*, establishes requirements and provides direction regarding documenting the procedures performed, evidence obtained, and conclusions reached in an audit.

Sufficient Appropriate Audit Evidence

4. The auditor must design and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion.
5. Sufficiency is the measure of the *quantity* of audit evidence. The quantity of audit evidence needed is affected by the following:
 - *Risk of material misstatement (in the audit of financial statements) or the risk associated with the control (in the audit of internal control over financial reporting)*. As the risk increases, the amount of evidence that the

auditor should obtain also increases. For example, ordinarily more evidence is needed to respond to significant risks.

- *Quality of the audit evidence obtained.* As the quality of the evidence increases, the need for additional corroborating evidence decreases. Obtaining more of the same type of audit evidence, however, cannot compensate for the poor quality of that evidence.

6. 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. Relevance and reliability are discussed in the following paragraphs.

Relevance and Reliability

7. *Relevance.* 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; and
- b. The timing of the audit procedure used to test the assertion or control.

8. *Reliability.* The reliability of evidence depends on the nature and source of the evidence and the circumstances under which it is obtained. For example, in general:

- Evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources
- The reliability of information generated internally by the company is increased when the company's controls over that information are effective
- Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly
- 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

9. The auditor is not expected to be an expert in document authentication. However, if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions and should determine the effect, if any, on the other aspects of the audit.

Using Information Produced by the Company

10. When using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit, by performing procedures to:^{1/}

- Test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information
- Evaluate whether the information is sufficiently precise and detailed for purposes of the audit

Financial Statement Assertions

11. In representing that the financial statements are presented fairly in conformity with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures. Those assertions can be classified into the following categories:

- *Existence or occurrence* – Assets or liabilities of the company exist at a given date, and recorded transactions have occurred during a given period.

^{1/} When using the work of a specialist engaged by management, see AU sec. 336, *Using the Work of a Specialist*. When using information produced by a service organization or a service auditor's report as audit evidence, see AU sec. 324, *Service Organizations*, and for integrated audits, Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

- *Completeness* – All transactions and accounts that should be presented in the financial statements are so included.
- *Valuation or allocation* – Asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts.
- *Rights and obligations* – The company holds or controls rights to the assets, and liabilities are obligations of the company at a given date.
- *Presentation and disclosure* – The components of the financial statements are properly classified, described, and disclosed.

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^{2/} of containing misstatements that would cause the financial statements to be materially misstated.^{3/}

Audit Procedures for Obtaining Audit Evidence

13. Audit procedures can be classified into the following categories:

- a. Risk assessment procedures^{4/} and
- b. Further audit procedures,^{5/} which consist of:
 - (1) Tests of controls and

^{2/} There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

^{3/} For an integrated audit, also see paragraph 28 of Auditing Standard No. 5.

^{4/} Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

^{5/} Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

- (2) Substantive procedures, including tests of details and substantive analytical procedures

14. Paragraphs 15-21 of this standard describe specific audit procedures. The purpose of an audit procedure determines whether it is a risk assessment procedure, test of controls, or substantive procedure.

Inspection

15. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or physically examining 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. An example of inspection used as a test of controls is inspection of records for evidence of authorization.

Observation

16. Observation consists of looking at a process or procedure being performed by others, e.g., the auditor's observation of inventory counting by the company's personnel, or of the performance of control activities. Observation can provide audit evidence about the performance of a process or procedure, but the evidence is limited to the point in time at which the observation takes place, and also is limited by the fact that the act of being observed may affect how the process or procedure is performed.

Note: AU sec. 331, *Inventories*, establishes requirements and provides direction regarding observation of the counting of inventory.

Inquiry

17. Inquiry consists of seeking information from knowledgeable persons in financial or nonfinancial roles within the company or outside the company. Inquiry may be performed throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

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.

Note: AU sec. 333, *Management Representations*, establishes requirements and provides direction regarding written management representations, including confirmation of management responses to oral inquiries.

Confirmation

18. A confirmation represents audit evidence obtained by the auditor as a direct response to the auditor from a third party. Confirmation procedures frequently are used in relation to account balances and their constituent parts, e.g., confirmation of receivables by communication with debtors. However, confirmations need not be restricted to these items. For example, if the auditor requests confirmation of the terms of a company's agreements or transactions with third parties, the confirmation request may be designed to ask if any modifications have been made to the agreement or if side agreements exist and, if so, what the relevant details are.

Note: AU sec. 330, *The Confirmation Process*, establishes requirements and provides direction regarding confirmations.

Recalculation

19. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Re-performance

20. Re-performance involves the independent execution of procedures or controls that were originally performed by company personnel.

Analytical Procedures

21. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of significant differences from expected amounts.

Note: AU sec. 329, *Substantive Analytical Procedures*, establishes requirements and provides direction on performing analytical procedures as substantive procedures.

Selecting Items for Testing to Obtain Audit Evidence

22. Designing substantive tests of details and tests of controls includes determining the means of selecting items for testing from among the items included in an account or based on the occurrences of a control. The auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure. The alternative means of selecting items for testing are:

- Selecting all items
- Selecting specific items
- Audit sampling

23. The particular means or combination of means of selecting items for testing that is appropriate depends on the nature of the audit procedure, the characteristics of the control or the items comprising the account being tested, and the evidence necessary to meet the objective of the audit procedure.

Selecting All Items

24. Selecting all items (100 percent examination) refers to testing the entire population of the occurrences of a control or items that comprise an account (or a stratum within that population). The following are examples of situations in which 100 percent examination might be applied:

- The population constitutes a small number of large value items;
- The audit procedure is designed to respond to a significant risk and other means of selecting items for testing do not provide sufficient appropriate audit evidence; or
- The audit procedure can be automated effectively and applied to the entire population.

Selecting Specific Items

25. Selecting specific items refers to testing all of the items in a population that have a specified characteristic, such as:

- *Key items.* The auditor may decide to select specific items within a population because they are important to accomplishing the objective of the audit procedure or exhibit some other characteristic, e.g., items that are suspicious, unusual, particularly risk-prone or that have a history of error.
- *All items over a certain amount.* The auditor may decide to examine items whose recorded values exceed a certain amount to verify a large proportion of the total amount of the items included in an account.

26. The auditor also might select specific items to obtain an understanding about matters such as the nature of the company or the nature of transactions.

27. The application of audit procedures to items that are selected as described in paragraphs 24 and 25 does not constitute audit sampling, and the results of those audit procedures cannot be projected to the entire population.^{6/}

Audit Sampling

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.

Note: AU sec. 350, *Audit Sampling*, establishes requirements and provides direction regarding audit sampling.

Inconsistency in, or Doubts about the Reliability of, Audit Evidence

29. If audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.

^{6/} If misstatements are identified in the selected items, see paragraphs 12-13 and paragraphs 17-19 of Proposed Auditing Standard, *Evaluating Audit Results*.

APPENDIX 8

Proposed Amendments to PCAOB Standards

Auditing Standards

AU sec. 110, "Responsibilities and Functions of the Independent Auditor"

Statement on Auditing Standard ("SAS") No. 1, "Codification of Auditing Standards and Procedures" section 110, "Responsibilities and Functions of the Independent Auditor" (AU sec. 110, "Responsibilities and Functions of the Independent Auditor") is amended as follows –

Within footnote 1 to paragraph .02, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*.

AU sec. 150, "Generally Accepted Auditing Standards"

SAS No. 95, "Generally Accepted Auditing Standards" (AU sec. 150, "Generally Accepted Auditing Standards"), as amended, is amended as follows –

- a. Within paragraph .02, in the third standard of field work, the word "competent" is replaced with the word "appropriate."
- b. Footnote 2 to paragraph .04 is deleted.

AU sec. 210, "Training and Proficiency of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 210, "Training and Proficiency of the Independent Auditor" (AU sec. 210, "Training and Proficiency of the Independent Auditor") is amended as follows –

The last sentence of paragraph .03 is replaced with –

The engagement partner must exercise a seasoned judgment in the varying degrees of his supervision and review of the work done and judgment exercised by his subordinates, who in turn must meet the responsibility attaching to the varying gradations and functions of their work.

AU sec. 230, "Due Professional Care in the Performance of Work"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 230, "Due Professional Care in the Performance of Work" (AU sec. 230, "Due Professional Care in the Performance of Work"), as amended, is amended as follows –

- a. The second and third sentences of paragraph .06 are replaced with –

The engagement partner should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client. The engagement partner is responsible for the assignment of tasks to, and supervision of, the members of the engagement team.^{fn4}
- b. Footnote 3 to paragraph .06 is deleted.
- c. Within footnote 4 to paragraph .06, the phrase "See section 311.11" is replaced with, "See paragraphs 22-24 of Proposed Auditing Standard, *Audit Planning and Supervision*."
- d. Footnote 6 to paragraph 11 is deleted.
- e. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."
- f. At the end of the fifth sentence of paragraph .12, the following parenthetical is added: "(See paragraph 9 of Proposed Auditing Standard, *Audit Evidence*.)"

AU sec. 310, "Appointment of the Independent Auditor"

SAS No. 1, "Codification of Auditing Standards and Procedures" section 310, "Appointment of the Independent Auditor" (AU sec. 310, "Appointment of the Independent Auditor"), as amended, is amended as follows –

- a. Within footnote ** to the title of the standard, the sentence referring to section 313, which is in parentheses, is deleted.
- b. In paragraph .02:
 - The word "assistants" is replaced with the term "engagement team members."

- The first reference to AU section 311, *Planning and Supervision*, is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*.
 - The second reference to AU section 311 is replaced with a reference to Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.
- c. In paragraph .02, the reference to AU section 313, *Substantive Tests Prior to the Balance-Sheet Date*, is deleted.
- d. In paragraph .03, the sentence referring to section 313, which is in parentheses, is deleted.
- e. Within footnote 3 to paragraph .06, the reference to paragraph .04 of section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to paragraph A2 of Proposed Auditing Standard, *Evaluating Audit Results*.

AU sec. 311, "Planning and Supervision"

SAS No. 22, "Planning and Supervision" (AU sec. 311, "Planning and Supervision"), as amended, is superseded.

AU sec. 9311, "Planning and Supervision: Auditing Interpretations of Section 311"

AU sec. 9311, "Planning and Supervision: Auditing Interpretation of Section 311" is superseded.

AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"

SAS No. 47, "Audit Risk and Materiality in Conducting an Audit" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), as amended, is superseded.

AU sec. 9312, "Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312"

AU sec. 9312, "Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312" is superseded.

AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date"

SAS No. 45, "Omnibus Statement on Auditing Standards – 1983" (AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date"), as amended, is superseded.

AU sec. 315, "Communications Between Predecessor and Successor Auditors"

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows –

- a. In the first sentence of paragraph .12, the word "competent" is replaced with the word "appropriate."
- b. In the first sentence of paragraph .18, the word "competent" is replaced with the word "appropriate."

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), as amended, is amended as follows –

- a. The second sentence of paragraph .01 is replaced with –

This section establishes requirements and provides direction relevant to fulfilling that responsibility, as it relates to fraud, in an audit of financial statements.^{fn 2/}
- b. In footnote 1 to paragraph .01, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is deleted.
- c. Footnote 2 to paragraph .01 is replaced with –

For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of the financial statements only.
- d. The following paragraph .01A is added–

Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, establishes requirements and provides direction regarding

the process of identifying and assessing risks of material misstatement of the financial statements. Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, establishes requirements and provides direction regarding designing and implementing appropriate responses to the risks of material misstatement. Proposed Auditing Standard, *Evaluating Audit Results*, establishes requirements and provides direction regarding the auditor's evaluation of audit results of whether he or she has obtained sufficient appropriate audit evidence.

e. In paragraph .02:

- The third through the sixth bullet points are deleted.
- The seventh bullet point is replaced with –

"Responding to fraud risks. This section discusses certain responses to fraud risks involving the nature, timing, and extent of audit procedures, including:

- Responses to assessed fraud risks relating to fraudulent financial reporting and misappropriation of assets (see paragraph .52 through .56).
- Responses to specifically address the fraud risks arising from management override of internal controls (see paragraphs .57 through .67)."

- The eighth bullet point is deleted.

f. Paragraph .03 is deleted.

g. Footnote 5 to paragraph .06 is replaced with –

The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

h. Paragraph .13, third sentence, the term "the risk of material misstatement due to fraud" is replaced with the term "fraud risks".

- i. Paragraphs .14 through .45 are deleted, along with the preceding heading, "Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud".
- j. Footnotes 8 through 19, related to paragraphs .14 through .45, are deleted.
- k. Paragraphs .46 through .50 are deleted. The heading preceding paragraph .46 is replaced with the heading, "Responding to Assessed Fraud Risks."
- l. Paragraph .51 is deleted. The heading preceding paragraph .51 is replaced with the heading, "Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed."
- m. Paragraph .52 is replaced with –

Paragraph 8 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, states that "the auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement due to error or fraud for each relevant assertion of each significant account and disclosure." Paragraph 12 of that Proposed Standard states that "the audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected."

Note: Paragraph 71.a. of Proposed Auditing Standard, *Identifying and Assessing the Risks of Material Misstatement*, indicates that a fraud risk is a significant risk. Accordingly, the requirement for responding to significant risks also applies to fraud risks.

- n. In paragraph .53:
 - The first sentence is replaced with –

The following are examples of responses to assessed fraud risks involving the nature, timing, and extent of audit procedures:
 - The fifth bullet point is replaced with –

Interviewing personnel involved in activities in areas where a fraud risk has been identified to obtain their insights about the risk and how controls address the risk (See paragraph 54 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*).

- o. Footnote 20 to paragraph .53 is replaced with –

AU sec. 329, *Substantive Analytical Procedures*, establishes requirements regarding performing analytical procedures as substantive tests.

- p. The heading preceding paragraph .54, "Additional Examples of Responses to Identified Risks of Misstatements Arising From Fraudulent Financial Reporting" is replaced with "Additional Examples of Audit Procedures Performed to Respond to Assessed Fraud Risks Relating to Fraudulent Financial Reporting."

- q. The first sentence in paragraph .54 is replaced with –

The following are additional examples of audit procedures that might be performed in response to assessed fraud risks relating to fraudulent financial reporting:

- r. In Paragraph .54 –

- In the last sentence of the first bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk".
- In the first sentence of the second bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk".
- In the first sentences of third bullet point and the accompanying paragraph to the third bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk".

- s. Footnotes 21 and 22 to paragraph .54 are amended as follows –

- The text of footnote 21 is replaced with "AU sec. 330, *The Confirmation Process*, establishes requirements regarding the confirmation process in audits of financial statements."

- The text of footnote 22 is replaced with "AU sec. 336, *Using the Work of a Specialist*, establishes requirements for an auditor who uses the work of a specialist in performing an audit of financial statements."
- t. The heading preceding paragraph .55, "Examples of Responses to Identified Risks of Misstatements Arising From Misappropriations of Assets" is replaced with the heading, "Examples of Audit Procedures Performed to Respond to Fraud Risks Relating to Misappropriations of Assets."
- u. In the first sentence of paragraph .55, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk".
- v. In paragraph .56:
 - The first and second sentences are replaced with –

The audit procedures performed in response to a fraud risk relating to misappropriation of assets usually will be directed toward certain account balances. Although some of the audit procedures noted in paragraphs .53 and .54 and in paragraphs 8 through 15 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, may apply in such circumstances, such as the procedures directed at inventory quantities, the scope of the work should be linked to the specific information about the misappropriation risk that has been identified.
 - In the third sentence, the words "design and" are added before the words "operating effectiveness."
- w. The heading preceding paragraph .57, "Responses to Further Address the Risk of Management Override of Controls," is replaced with the heading "Audit Procedures Performed to Specifically Address the Risk of Management Override of Controls."
- x. The third sentence of paragraph .57 is replaced with –

Accordingly, as part of auditor's responses that address fraud risks, the procedures described in paragraphs .58 through .67 should be performed to specifically address the risk of management override of controls.

y. Footnote 23 to paragraph .58 is replaced with –

See paragraphs 28 through 32 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

z. In paragraph .61:

- In the first sentence of the first bullet point, the term "the risk of material misstatement due to fraud" is replaced with the term "fraud risk."
- In the second bullet point, the last two sentences are replaced with the following –

Effective controls over the preparation and posting of journal entries and adjustments may affect the extent of substantive testing necessary, provided that the auditor has tested the controls. However, even though controls might be implemented and operating effectively, the auditor's substantive procedures for testing journal entries and other adjustments should include the identification and substantive testing of specific items.

- In item (f) of the fifth bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."
- The last sentence of the fifth bullet point is replaced with –

In audits of entities that have multiple locations or components, the auditor should determine whether to select journal entries from locations based on factors set forth in paragraphs 11 through 14 of Proposed Auditing Standard, *Audit Planning and Supervision*.

aa. The last sentence of paragraph .63 is replaced with –

Paragraphs 26 and 27 of Proposed Auditing Standard, *Evaluating Audit Results*, discuss the auditor's responsibilities for assessing bias in accounting estimates and the effect of bias on the financial statements.

bb. Paragraphs .68 through .78 are deleted, along with the preceding heading "Evaluating Audit Evidence."

cc. Footnotes 26 through 36, related to paragraphs .68 through .78 are deleted.

dd. In the first sentence of the paragraph .80, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk".

ee. The last sentence of paragraph .80 is replaced with –

The auditor also should evaluate whether the absence of or deficiencies in controls that address fraud risks or otherwise help prevent, deter, and detect fraud (see paragraph 20 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*) represent significant deficiencies that should be communicated to senior management and the audit committee.

ff. The first sentence of paragraph .81 is replaced with –

The auditor also should consider communicating other fraud risks, if any, identified by the auditor.

gg. In paragraph .83:

- The reference in the first bullet point to paragraphs .14 through .17 is replaced with paragraphs 46 through 50 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.
- The term "risks of material misstatement due to fraud" in the first sentence of the second bullet point is replaced with the term "fraud risks." The reference in the second bullet point to paragraphs .19 through .34 is replaced with paragraphs 38 through 45, paragraphs 51 through 55, and paragraphs 72 through 73 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.
- The third bullet point is replaced with –

The fraud risks that were identified at the financial statement and assertion levels (see paragraphs 56 through 73 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*), and the linkage of those risks to the auditor's response (see paragraphs 5 through 15 of Proposed Auditing

Standard, *The Auditor's Responses to the Risks of Material Misstatement*.)

- Within the fourth bullet point, the term "risk of material misstatement due to fraud" in the first sentence is replaced with the term "fraud risk," and the reference to paragraph .41 is replaced with a reference to paragraph 69 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.
- The fifth bullet point is replaced with –

The results of the procedures performed to address the assessed fraud risks, including those to further address the risk of management override of controls (see paragraph 15 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatements*.)
- The reference in the sixth bullet point to paragraphs .68 through .73 is replaced with a reference to paragraphs 5 through 9 of Proposed Auditing Standard, *Evaluating Audit Results*.

hh. Paragraph .84 and the accompanying heading, "Effective Date," are deleted.

ii. The first sentence of paragraph .85 is replaced with –

This appendix contains examples of risk factors discussed in paragraphs 66 through 68 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

AU sec. 317, "Illegal Acts by Clients"

SAS No. 54, "Illegal Acts by Client" (AU sec. 317, "Illegal Acts by Clients"), as amended, is amended as follows –

a. The last sentence of paragraph .13 is replaced with –

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.

- b. In paragraph .19, the word "competent" is replaced with the word "appropriate."

AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"

SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), as amended, is superseded.

AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"

SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"), as amended, is amended as follows –

- a. In the first sentence of paragraph .02, the word "competent" is replaced with the word "appropriate."
- b. Within footnote 3 to paragraph .04, the reference to AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.
- c. In the first sentence of paragraph .18, the word "competent" is replaced with the word "appropriate."
- d. Within footnote 5 to paragraph .18, the reference to AU 326, *Evidential Matter*, paragraph .19c. is replaced with a reference to Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, paragraph 42.
- e. Within footnote 8 to paragraph 27, the reference to AU sec. 311, *Planning and Supervision*, paragraphs .11 through .13 is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*, paragraphs 22 through 24.

AU sec. 324, "Service Organizations"

SAS No. 70, "Service Organizations" (AU sec. 324, "Service Organization), as amended, is amended as follows –

- a. In the first sentence of paragraph .07, the reference to section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.
- b. In the first sentence of paragraph .16, the reference to section 319.90 through .99, is replaced with a reference to Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, paragraph 18 and paragraphs 29 through 31.
- c. In the second sentence of paragraph .23, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*.

AU sec. 326, "Evidential Matter"

SAS No. 31, "Evidential Matter" (AU sec. 326, "Evidential Matter"), as amended, is superseded.

AU sec. 9326, "Evidential Matter: Auditing Interpretations of Section 326"

AU sec. 9326, "Evidential Matter: Auditing Interpretations of Section 326," as amended, is amended –

- a. Paragraphs .01-.05 are deleted
- b. The reference in paragraph .10 to section 326, *Evidential Matter*, paragraph .25, is replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*, paragraph 35.
- c. In the first and second sentences of paragraph .10, the word "competent" is replaced with the word "appropriate."
- d. The last two sentences of paragraph .12 are deleted.
- e. In the second sentence of paragraph .12, the word "competent" is replaced with the word "appropriate."
- f. In the first sentence of paragraph .13, the word "competent" is replaced with the word "appropriate."

- g. In paragraph .17, the word "competent" is replaced with the word "appropriate."
- h. In the second sentence of paragraph .21, the word "competent" is replaced with the word "appropriate."
- i. In the fourth sentence of paragraph .22, the word "competent" is replaced with the word "appropriate."
- j. In paragraph .23, the word "competent" is replaced with the word "appropriate."
- k. Paragraphs .24-.41 are deleted.

AU sec. 328, "Auditing Fair Value Measurements and Disclosures"

SAS No. 101, "Auditing Fair Value Measurements and Disclosures" (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), as amended, is amended as follows –

- a. In the first sentence of paragraph .03, the word "competent" is replaced with the word "appropriate."
- b. The reference in paragraph .11 to Section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.
- c. The reference in paragraph .14 to section 319 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, paragraph A5, second note. The reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, is deleted.
- d. Within paragraph .25, in the second sentence in the second bullet point and the first sentence in the third bullet point, the word "competent" is replaced with the word "appropriate."
- e. In the second sentence of paragraph .32, the word "competent" is replaced with the word "appropriate."

- f. In the first sentence of paragraph .42, the word "competent" is replaced with the word "appropriate."
- g. In footnote 8 to paragraph 43, the reference to "section 431, *Adequacy of Disclosure in Financial Statements*" is replaced with "paragraph 31 of Proposed Auditing Standard, *Evaluating Audit Results*."
- h. In the second sentence of paragraph .44, the word "competent" is replaced with the word "appropriate."
- i. The reference in paragraph .47 to section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraphs .36 through 41, is replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*, paragraphs 12 through 18 and 24 through 27.

AU sec. 329, "Analytical Procedures"

SAS No. 56, "Analytical Procedures" (AU sec. 329, "Analytical Procedures"), as amended, is amended as follows –

- a. The title of the standard "Analytical Procedures" is replaced with "Substantive Analytical Procedures."
- b. The text of paragraph .01 is replaced with –

This section establishes requirements regarding the use of substantive analytical procedures in an audit.

Note: Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, establishes requirements regarding performing analytical procedures as a risk assessment procedure in identifying and assessing the risks of material misstatement.

Note: Proposed Auditing Standard, *Evaluating Audit Results*, establishes requirements on performing analytical procedures as part of the overall review stage of the audit.

- c. Paragraph .03 is deleted.
- d. The text of paragraph .04 is replaced with –

Analytical procedures are used as a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions. In some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

- e. Paragraphs .06 - .08 and the accompanying heading are deleted.
- f. At the end of paragraph .09, a new sentence is added –

(See paragraph 11 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.)

- g. Within footnote 1 to paragraph .09, the reference to section 326, *Evidential Matter*, is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*.
- h. Footnote 2 to paragraph .20 is deleted.
- i. In paragraph .21:
 - In the fourth sentence, the word "likely" is deleted.
 - The reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, is replaced with the reference to Proposed Auditing Standard, *Evaluating Audit Results*.
- j. Footnote 3 to paragraph .21 is deleted.
- k. Paragraphs .23 and .24 and the accompanying headings are deleted.

AU sec. 330, "The Confirmation Process"

SAS No. 67, "The Confirmation Process" (AU sec. 330, "The Confirmation Process"), is amended as follows –

- a. The references in paragraph .02 to section 312, *Audit Risk and Materiality in Conducting an Audit*, and section 313, *Substantive Tests Prior to the Balance-Sheet Date*, are replaced with a reference to Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

- b. The reference in paragraph .05 to section 312 is replaced with a reference to Proposed Auditing Standard, *Audit Risk*.
- c. The second sentence of paragraph .06 is replaced with –

See proposed Auditing Standard, *Audit Evidence*, paragraph 8, which discusses reliability of audit evidence.
- d. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate." The reference in the third sentence to Section 326 is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*.
- e. In the first sentence of paragraph .24, the word "competence" is replaced with the word "appropriateness."
- f. In the last sentence of paragraph .27, the word "competent" is replaced with the word "appropriate."

AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"

SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investment in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), as amended, is amended as follows –

- a. The reference in paragraph .01 to section 326, *Evidential Matter*, paragraphs .03 – .08, is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*, paragraphs 11 and 12.
- b. The reference in paragraph .06, to Section 311, *Planning and Supervision*, is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*.
- c. The first and second sentences of paragraph .07 are deleted. The third sentence is replaced with –

The auditor should design and perform audit procedures regarding relevant assertions of derivatives and investments in securities that are based on and that address the risks of material misstatement in those assertions.

- d. The reference in paragraph .09 to Section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.
- e. The reference in paragraph .11 to Section 319.47 is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, paragraphs 18 through 32.
- f. The reference to section 319 in paragraph .15 is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.
- g. The last sentence of paragraph .35, is replaced with –

In addition, Proposed Auditing Standard, *Evaluating Auditing Results*, paragraphs 24 through 27, describes the auditor's responsibilities for assessing bias in accounting estimates.
- h. In paragraph .43, subpart a., the word "competent" is replaced with the word "appropriate."
- i. In paragraph .51, the last sentence is replaced with –

(See paragraph 31 of Proposed Auditing Standard, *Evaluating Audit Results*.)
- j. In paragraph .57, subpart c., the word "competent" is replaced with the word "appropriate."

AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows –

- a. Footnote 4 to paragraph .06, is replaced with –

Proposed Auditing Standard, *Evaluating Audit Results*, indicates that a misstatement can arise from error or fraud and discusses the auditor's responsibilities for evaluating accumulated misstatements.

- b. Within footnote 6 to paragraph .06, the reference to Section 312, is replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*, paragraph 11.
- c. Within footnote 7 to paragraph .06, the reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, paragraphs .38 through .40, is replaced with a reference to section 316, *Consideration of Fraud in a Financial Statement Audit*, paragraphs .79 through .82.

AU sec. 334, "Related Parties"

SAS No. 45 "Related Parties" (AU sec. 334 "Related Parties"), is amended as follows –

- a. In the second sentence of paragraph .09, the word "competent" is replaced with the word "appropriate."
- b. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate".
- c. In footnote 8 to paragraph .11, the reference to "section 431, Adequacy of Disclosure in Financial Statements" is replaced with "paragraph 31 of Proposed Auditing Standard, *Evaluating Audit Results*."

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334"

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334," is amended as follows –

Within footnote 4 to paragraph .17, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Proposed Auditing Standard, *Audit Risk*.

AU sec. 336, "Using the Work of a Specialist"

SAS No. 73, "Using the Work of a Specialist" (AU sec. 336 "Using the Work of a Specialist"), is amended as follows –

- a. The reference in paragraph .05 to section 311, *Planning and Supervision*, is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*.

- b. In the last sentence of paragraph .06, the word "competent" is replaced with the word "appropriate."
- c. In the first and last sentences of paragraph .13, the word "competent" is replaced with the word "appropriate."

AU sec. 9336 "Using the Work of a Specialist: Auditing Interpretations of Section 336"

AU sec. 9336, "Using the Work of a Specialist: Auditing Interpretations of Section 336," is amended as follows –

- a. In the second sentence of paragraph .04, the word "competent" is replaced with the word "appropriate."
- b. In paragraph .05, the word "competent" is replaced with the word "appropriate."
- c. In the second sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."
- d. The penultimate sentence of paragraph .15, is replaced with –

Proposed Auditing Standard, *Audit Evidence*, paragraph 6, states, "to be appropriate, audit evidence must be both relevant and reliable."

AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"

SAS No. 59, "The Auditor's Consideration of an Entity's Ability to Continue as Going Concern" (AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"), as amended, is amended as follows –

The reference in paragraph .02, to section 326, *Evidential Matter*, is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*.

AU sec. 342, "Auditing Accounting Estimates"

SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), as amended, is amended as follows –

- a. In the first sentence of paragraph .01, the word "competent" is replaced with the word "appropriate."
- b. In the first sentence of paragraph .07, the word "competent" is replaced with the word "appropriate."
- c. The text of footnote 3 to paragraph .07 is replaced with –

See paragraph 31 of Proposed Auditing Standard, *Evaluating Audit Results*.
- d. The reference in paragraph .08 subparagraph b.1. to section 311, *Planning and Supervision*, is replaced with Proposed Auditing Standard, *Audit Planning and Supervision*.
- e. Paragraph .14, is replaced with –

Proposed Auditing Standard, *Evaluating Audit Results*, paragraphs 24 through 27, discuss the auditor's responsibilities for assessing bias and evaluating accounting estimates in relationship to the financial statements taken as a whole.

AU sec. 9342, "Auditing Accounting Estimates: Auditing Interpretations of Section 342"

AU sec. 9342, "Auditing Accounting Estimates: Auditing Interpretations of Section 342," is amended as follows –

In the second sentence of paragraph .02, the word "competent" is replaced with the word "appropriate."

AU sec. 350, "Audit Sampling"

SAS No. 39, "Audit Sampling" (AU sec. 350, "Audit Sampling"), as amended, is amended as follows –

- a. Within footnote 2 to paragraph .02, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*.
- b. The last sentence of paragraph .03 is replaced with –

Either approach to audit sampling can provide sufficient evidential matter when applied properly. This section applies to both nonstatistical and statistical sampling.

- c. Paragraph .04 is deleted.
- d. Within paragraph .06, the first sentence is deleted; in the last sentence, the word "competence" is replaced with the word "appropriateness," and the following Note is added to the paragraph:

Note: Proposed Auditing Standard, *Audit Evidence*, discusses the appropriateness of audit evidence, and Proposed Auditing Standard, *Evaluating Audit Results*, discusses the auditor's responsibilities for evaluating the sufficiency and appropriateness of audit evidence.

- e. Paragraph .08 is deleted.
- f. The sentence in paragraph .09 referring to section 313, which is in parentheses, is deleted; the following note is added to paragraph .09 –

Note: Paragraphs 5 through 10 of Proposed Auditing Standard, *Audit Risk*, describes audit risk and its components in a financial statement audit – the risk of material misstatement (consisting of inherent risk and control risk) and detection risk.

- g. The reference in paragraph .11 to section 311, *Planning and Supervision*, is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*. The sentence referring to section 313, which is in parentheses, is deleted.
- h. The second sentence of paragraph .15, is replaced with –
See also Proposed Auditing Standard, *Audit Planning and Supervision*.
- i. The reference in the first bullet in paragraph .16 to section 326, *Evidential Matter*, is deleted. In the second bullet, the phrase "preliminary judgment about materiality" is replaced with the phrase "Tolerable misstatement. (See paragraph .18-.18A.)"

- j. Paragraph .18 is replaced with –

Evaluation in monetary terms of the results of a sample for a substantive test of details contributes directly to the auditor's purpose, since such an evaluation can be related to his or her judgment of the monetary amount of misstatements that would be material. When planning a sample for a substantive test of details, the auditor should consider how much monetary misstatement in the related account balance or class of transactions may exist, in combination with other misstatements, without causing the financial statements to be materially misstated. This maximum monetary misstatement for the balance or class is called *tolerable misstatement*.

- k. Paragraph .18A is added –

Paragraphs 8 - 9 of Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*, describe the auditor's responsibilities for determining tolerable misstatement at the account or disclosure level. When the population to be sampled constitutes a portion of an account balance or transaction class, the auditor should determine tolerable misstatement for the population to be sampled for purposes of designing the sampling plan. Tolerable misstatement for the population to be sampled ordinarily should be less than tolerable misstatement for the account balance or transaction class to allow for the possibility that misstatement in the portion of the account or transaction class not subject to audit sampling, individually or in combination with other misstatements, would cause the financial statements to be materially misstated.

- l. Paragraph .20 is deleted.

- m. The first sentence of paragraph .21, is replaced with the following sentence –

The sufficiency of tests of details for a particular account balance or class of transactions is related to the individual importance of the items examined as well as to the potential for material misstatement.

- n. Paragraph .23 is replaced with –

To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account

tolerable misstatement for the population; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected size and frequency of misstatements.

- o. Paragraph .23A is added –

Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

- p. The last sentence of paragraph .25 is replaced with –

The auditor also should evaluate whether the reasons for his or her inability to examine the items have implications in relation to his or her risk assessments (including the assessment of fraud risk) the implications on the integrity of management or employees, and the possible effect on other aspects of the audit.

- q. Footnote 6 to paragraph .26 is replaced with –

Paragraphs 11 through 23 of Proposed Auditing Standard, *Evaluating Audit Results*, discuss the auditor's consideration of differences between the accounting records and the underlying facts and circumstances.

- r. Within footnote 7 to paragraph .32, the reference to section 319.85 is deleted. In the first sentence of the footnote, the phrase "often plans" is replaced with the phrase "may plan." The last sentence of the footnote, which is in brackets, is deleted.

- s. The following sentences are added to the end of paragraph .38 –

When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical

approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

- t. The fifth sentence of paragraph .39 is replaced with –

Paragraphs 44 through 46, of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, describe the auditor's responsibilities for performing procedures between the interim date of testing and period end.

- u. In paragraph .39, the last sentence, which is in brackets, is deleted.

- v. In paragraph .44:

- The first sentence is replaced with –

In some circumstances the auditor may design a sample that will be used for dual purposes: as a test of control and a substantive test.

- The third sentence is replaced with –

For example, an auditor designing a test of a control over entries in the voucher register may design a related substantive test at a risk level that is based on an expectation of reliance on the control to assess control risk at less than the maximum.

- The fifth sentence is replaced with –

In evaluating such tests, deviations from the control that was tested and monetary misstatements should be evaluated separately using the risk levels applicable for the respective purposes.

- The following Note is added to the paragraph –

Note: Paragraph 47 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, provides additional discussion of the auditor's responsibilities for performing dual-purpose tests.

- w. The reference in paragraph .45 to paragraph .04 is changed to paragraph .03.
- x. In item 2 of paragraph .48, the last sentence is deleted.
- y. The sentence in item 6 of paragraph .48, referring to section 313, which is in parentheses, is deleted.
- z. Within footnote 1 to item 4 in paragraph .48, the sentence referring to section 313, which is in parentheses, is deleted.

AU sec. 9350, "Audit Sampling: Auditing Interpretations of Section 350"

AU sec. 9350, "Audit Sampling: Auditing Interpretations of Section 350" is superseded.

AU sec. 380, "Communication With Audit Committees"

SAS No. 61, "Communication With Audit Committees" (AU sec. 380, "Communication With Audit Committees") as amended, is amended as follows –

The reference in footnote 5 to paragraph .10 to section 316A.38 -.40 is replaced with a reference to AU sec. 316.79 - .82. The reference to section 316A is changed to section 316.

AU sec. 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles"

SAS No. 69, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles" (AU sec. 411, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles"), as amended, is amended as follows –

- a. In paragraph .04, the reference to section 431 is replaced with a reference to paragraph 31 of Proposed Auditing Standard, *Evaluating Audit Results*.
- b. The reference in footnote 1 to paragraph .04 to 312.10 is replaced with a reference to Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*.

AU sec. 431, "Adequacy of Disclosure in Financial Statements"

SAS No. 32, "Adequacy of Disclosure in Financial Statements" (AU sec. 431, "Adequacy of Disclosure in Financial Statements"), as amended, is superseded.

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

SAS No. 58, "Reports on Audited Financial Statements" (AU sec. 508 "Reports on Audited Financial Statements"), as amended, is amended as follows –

- a. In paragraph 18C, the phrase "and in AU sec. 431" is deleted.
- b. In paragraph .20a., the word "competent" is replaced with the word "appropriate."
- c. In the second sentence of paragraph .22, the word "competent" is replaced with the word "appropriate."
- d. In the third sentence of paragraph .24, the word "competent" is replaced with the word "appropriate."
- e. In footnote 15 to paragraph .38, the first sentence is replaced with –

In this context, practicable means that the information is reasonably obtainable from management's accounts and records and that providing the information in the report does not require the auditor to assume the position of a preparer of financial information.

- f. The references in paragraph .49, to section 312, *Audit Risk and Materiality in Conducting an Audit*, and to section 342, *Auditing Accounting Estimates*, are replaced with a reference to Proposed Auditing Standard, *Evaluating Audit Results*, paragraph 13.
- g. In the first sentence of paragraph .63, the word "competent" is replaced with the word "appropriate."
- h. In paragraph .66, the second sentence is replaced with –

(See paragraph 31 of Proposed Auditing Standard, *Evaluating Audit Results*.)

AU sec. 9508, "Reports on Audited Financial Statements: Auditing Interpretations of Section 508"

AU sec. 9508, "Reports on Auditing Financial Statements: Auditing Interpretations of Section 508", is amended as follows –

In paragraph .02, the word "competent" is replaced with the word "appropriate."

AU sec. 530, "Dating of the Independent Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 530, "Dating of the Independent Auditor's Report" (AU sec. 530, "Dating of the Independent Auditor's Report"), as amended, is amended as follows –

- a. In the first sentence of paragraph .01, the word "competent" is replaced with the word "appropriate."
- b. In the second note to paragraph .01, the word "competent" is replaced with the word "appropriate."
- c. In the first sentence of paragraph .05, the word "competent" is replaced with the word "appropriate."

AU sec. 543, "Part of Audit Performed by Other Independent Auditors"

SAS No. 64, "Part of Audit Performed by Other Independent Auditors" (AU sec. 543 Part of Audit Performed by Other Independent Auditors") is amended as follows –

Within paragraph .12 –

- Subparagraph b is replaced with –
A list of significant risks, the auditor's responses, and the results of the auditor's related procedures.
- Subparagraph f is replaced with –
A schedule of accumulated misstatements, including a description of the nature and cause of each accumulated misstatement, and an evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543"

AU sec. 9543, "Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543," is amended as follows –

- a. Paragraph .16 is replaced with –

Interpretation – The principal auditor's response should ordinarily be made by the engagement partner. The engagement partner should take those steps that he considers reasonable under the circumstances to be informed of known matters pertinent to the other auditor's inquiry. For example, the engagement partner may inquire of engagement team members responsible for various aspects of the engagement or he may direct engagement team members to bring to his attention any significant matters of which they become aware during the audit. The principal auditor is not required to perform any procedures directed toward identifying matters that would not affect his audit or his report.

- b. Footnote 4 to paragraph .16 is deleted.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), as amended, is amended as follows –

- a. Within footnote 7 to paragraph .11 the first sentence is replaced with –

Proposed Auditing Standard, *Evaluating Audit Results*, paragraphs 10 through 23, require the auditor to accumulate and evaluate the misstatements identified during the audit.

- b. The reference in paragraph .13 to section 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.
- c. Within the last sentence of paragraph .16, the title of section 329, "Analytical Procedures", is replaced with "Substantive Analytical Procedures."
- d. Footnote 20, to paragraph .26 is deleted.

- e. The reference in paragraph .56 subparagraph C5 to section 319 is replaced with a reference to section 316.

Auditing Standard No. 3, *Audit Documentation*

Auditing Standard No. 3, *Audit Documentation*, as amended, is amended as follows –

- a. Within paragraph 3, subparagraph b is replaced with –

Supervisory personnel who review documentation prepared by other members of the engagement team.

- b. Paragraph 9A is added –

Documentation of risk assessment procedures and responses to risks of misstatement should include (1) a summary of the identified risks of misstatement and the auditor's assessment of risks of material misstatement at the financial statement and assertion levels and (2) the auditor's responses to the risks of material misstatement, including linkage of the responses to those risks.

- c. Within paragraph 12 –

- At subparagraph a., a footnote reference 2A has been added at the end of the first sentence;

See paragraphs 12 through 13 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, and paragraphs .66-.67 of AU Section 316, *Consideration of Fraud in a Financial Statement Audit*.

and the second sentence has been deleted.

- Subparagraph b. is replaced with –

Results of auditing procedures that indicate a need for significant modification of planned auditing procedures, the existence of material misstatements (including omissions in the financial statements), the existence of significant deficiencies or material weaknesses in internal control over financial reporting.

- Subparagraph c. is replaced with –

Accumulated misstatements and evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.
 - Footnote 2B is added to subparagraph c –

See paragraphs 10 through 23 of Proposed Auditing Standard, *Evaluating Audit Results*.
 - Subparagraph d is replaced with –

Disagreements among members of the engagement team or with others consulted on the engagement about final conclusions reached on significant accounting or auditing matters including the basis for the final resolution of those disagreements. If an engagement team member disagrees with the final conclusions reached, he or she should document that disagreement.
 - Subparagraph e-1. is added –

Risks of material misstatement that are determined to be significant risks, and the results of the auditing procedures performed in response to those risks.
 - Subparagraph f is replaced with –

Significant changes in the auditor's risk assessments, including risks that were not identified previously, and the modifications to audit procedures or additional audit procedures performed in response to those changes.
 - Footnote 2C is added to subparagraph f –

See paragraph 74 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement* and paragraph 35 of Proposed Auditing Standard, *Evaluating Audit Results*.
- d. Within paragraph 19 -
- Subparagraph b is replaced with –

A list of significant risks, the auditor's responses, and the results of the auditor's related procedures.

- Subparagraph f is replaced with –

A schedule of accumulated misstatements, including a description of the nature and cause of each accumulated misstatement, and an evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

- e. Paragraph 21 is deleted.

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, as amended, is amended as follows –

- a. Within the note to paragraph 10, the reference to AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.
- b. In the first sentence of paragraph 18, the word "competent" is replaced with the word "appropriate."

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

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, is amended as follows –

- a. In the second sentence of paragraph 3, the word "competent" is replaced with the word "appropriate."
- b. In the first sentence of paragraph 9, the phrase "any assistants" is replaced with the phrase "the members of the engagement team".
- c. Within footnote 10 to paragraph 14, the reference to paragraphs .19 through .42 of AU sec. 316, *Consideration of Fraud in a Financial*

Statement Audit, is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

- d. The reference in paragraph 15 to AU sec. 316.44 and .45 is replaced with a reference to paragraphs 72 through 73 of the Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.
- e. Within footnote 11 to paragraph 20, the reference to AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, is replaced with a reference to Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*.
- f. Within footnote 12 to paragraph 28, the reference to AU sec. 326, *Evidential Matter*, is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*.
- g. Within footnote 13 to the note to paragraph 31, the reference to AU sec. 312.39 is replaced with a reference to paragraphs 13 and 14 of the Proposed Auditing Standard, *Evaluating Auditing Results*. The reference to AU sec. 316.50 is replaced with a reference to paragraph 5 of the Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.
- h. The references in paragraph 36 to paragraphs .16 through .20, .30 through .32, and .77 through .79 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, are replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, paragraph 62 and Appendix B.
- i. In the first sentence of paragraph 51, the word "competent" is replaced with the word "appropriate."
- j. In the first sentence of paragraph 89, the word "competent" is replaced with the word "appropriate."
- k. Within the note to paragraph C6, the word "competent" is replaced with the word "appropriate."

Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*

Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* is amended as follows –

- a. Footnote 3 to paragraph 4 is deleted.
- b. In paragraph 10, the reference to section 431 is replaced with a reference to paragraph 31 of Proposed Auditing Standard, *Evaluating Audit Results*.

Auditing Standard No. 7, *Engagement Quality Review*

Auditing Standard No. 7, *Engagement Quality Review* is amended as follows –

- a. Footnote 3 to paragraph 5 is replaced with –

The term "engagement partner" has the same meaning as the "practitioner-in-charge of an engagement" in PCAOB interim quality control standard QC sec. 40, *The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement*. QC sec. 40 describes the competencies required of a practitioner-in-charge of an attest engagement.

- b. In paragraph 10, the note following subparagraph b is replaced with –

Note: A *significant risk* is a risk of material misstatement that requires special audit consideration.

Ethics Standards

ET sec. 102, "Integrity and Objectivity"

ET sec. 102, "Integrity and Objectivity," is amended as follows –

Within footnote 1 to paragraph .05, the reference to SAS No. 22, *Planning and Supervision* [AU Section 311] is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*.

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APPENDIX 9

Additional Discussion of New Proposed Auditing Standards and Comments on Original Standards Proposed in October 2008

This appendix discusses the new proposed standards in Appendices 1-7 and the related amendments to PCAOB standards in Appendix 8. In particular, this appendix discusses changes to existing PCAOB standards and responses to comments received on the standards proposed in October 2008 ("original proposed standards") and related amendments.

General Areas of Comment on the Original Proposed Standards

The following paragraphs discuss general areas of comment on the original proposed standards and related amendments, as well as certain changes to the original proposed standards and related amendments in light of those comments.

1. Comparison with the Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

In developing its original proposed standards, the Board took into account, among other things, the risk assessment standards of the International Auditing and Assurance Standards Board ("IAASB").^{1/} Several comments received on the original proposed standards related to differences between the IAASB standards and the original proposed standards. Also, many commenters referred to provisions of the IAASB standards when suggesting revisions to the original proposed standards.

The Board has considered these comments in developing the new proposed standards. Some revisions in the new proposed standards have resulted in eliminating differences from IAASB standards. However, because the Board's standards must be appropriate for audits of issuers and consistent with the Board's statutory mandate "to oversee the audit of public companies that are subject to the securities laws...in order to protect the interests of investors and further the public interest in the preparation of

^{1/} After the Board released its original proposed standards, the Auditing Standards Board of the American Institute of Certified Public Accountants ("ASB") issued a proposed update of its risk assessment standards as part of its clarity project.

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informative, accurate, and independent audit reports,"^{2/} its standards necessarily will differ in some respects from IAASB standards.

Some differences from the IAASB standards reflect the Board's view that particular procedures described in the IAASB standards are not necessary for audits of issuers or that additional procedures not described in the IAASB standards are necessary. For example, the new proposed standards contain certain requirements adapted from existing PCAOB standards that are not described in IAASB standards. Also, certain differences in requirements are necessary to make the new proposed standards consistent with relevant provisions of the federal securities laws or other existing standards or rules of the Board.

Subsequent sections of this appendix discuss the Board's responses to specific comments received on the original proposed standards, including those related to the use of provisions in the IAASB standards. Appendix 10 of this release discusses specific differences between the new proposed standards and the analogous standards of the IAASB and the Auditing Standards Board of the American Institute of Certified Public Accountants ("ASB").

2. Alignment with Auditing Standard No. 5

Section 2.A. of this release discusses the Board's objective regarding aligning its risk assessment standards with Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

Several commenters supported the Board's efforts to align the risk assessment standards with Auditing Standard No. 5, agreeing that, in an integrated audit of financial statements and internal control over financial reporting ("integrated audit"), the risk assessment process is the same for both the audit of financial statements and the audit of internal control over financial reporting ("audit of internal control"). However, some commenters observed that, on the one hand, the original proposed standards did not include certain essential risk assessment procedures from Auditing Standard No. 5 that also applied to financial statement audits, and, on the other hand, the original proposed standards contained certain requirements regarding testing controls and evaluating audit results that applied only to the audit of internal control and are already included in Auditing Standard No. 5. Those commenters suggested incorporating into the risk

^{2/} Section 101 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7211.

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assessment standards all of the Auditing Standard No. 5 requirements regarding risk assessment procedures and removing from the risk assessment standards all requirements for testing controls and evaluating audit results that apply only to the audit of internal control.

The new proposed standards incorporate the Auditing Standard No. 5 requirements related to identifying and assessing risks of material misstatement that also apply to financial statement audits. The new proposed standards omit requirements related only to the audit of internal control. As previously stated, the Board does not propose removing the requirements regarding risk assessment procedures from Auditing Standard No. 5 because those requirements are important to understanding the other provisions of Auditing Standard No. 5 for performing an audit of internal control.

3. Consideration of Fraud in the Audit

Section 2.B. discusses the Board's objectives regarding emphasizing the auditor's responsibilities for consideration of fraud by incorporating into its risk assessment standards the requirements for identifying and responding to risks, of material misstatement due to fraud ("fraud risks") and evaluating audit results from AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.^{3/}

The views of commenters on the approach taken in the original proposed standards were mixed. Some commenters supported the approach because it placed greater emphasis on the auditor's responsibilities for consideration of fraud. Others indicated views that all of the requirements regarding fraud should be presented in a single auditing standard or were ambivalent about whether the changes would have an effect on audit practice.

The new proposed standards continue to include relevant requirements from AU sec. 316. The Board has observed from its oversight activities instances in which auditors have performed the procedures required in AU sec. 316 mechanically, without using the procedures to develop insights on fraud risk or modify the audit plan to

^{3/} Like the original proposed standards, the new proposed standards incorporate paragraphs .14 -.51 and .68 -.78 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. Accordingly, those paragraphs would be removed from AU sec. 316 by means of a related amendment. See Appendix 8.

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address the risk and instances in which firms have failed to respond appropriately to identified fraud risks.

These kinds of deficiencies suggest that some auditors may view the consideration of fraud as an isolated, mechanical process rather than an integral part of audits under existing PCAOB standards. This integration would emphasize to auditors that assessing and responding to the risk of fraud is an integral part of an audit in accordance with existing PCAOB standards, rather than a separate consideration. Such integration also should prompt auditors to make a more thoughtful and thorough assessment of the risks affecting the financial statements, including fraud risks, and to develop appropriate audit responses. Furthermore, AU sec. 316, as amended, will continue to provide relevant information on determining the necessary procedures for considering fraud in a financial statement audit.

4. Requirements and the Application of Judgment

Some commenters expressed a view that the original proposed standards contained requirements that were "too prescriptive," limiting the auditor's ability to "use professional judgment or scale the audit." For example, the commenters observed that the original proposed standard on identifying and assessing risks of material misstatement had more requirements than the related IAASB standard. They also observed that the requirements in the original proposed standards did not refer to the auditor's judgment, particularly when corresponding requirements in the IAASB standards did so.

Existing PCAOB standards recognize that the auditor uses judgment in planning and performing audit procedures and evaluating the evidence obtained from those procedures.^{4/} As under the existing PCAOB standards, auditors would need to exercise judgment in fulfilling the requirements of the new proposed standards in the particular circumstances. Making references to judgment in selected portions of the standards, however, could be misinterpreted as indicating that judgment is required only in certain aspects of the audit. Instead of referring to judgment selectively, the new proposed standards set forth the principles necessary for meeting the requirements of the new proposed standards, and allow the auditor to determine the most appropriate way to comply with the requirements in the circumstances. Also, the Board has re-examined

^{4/} See, e.g., paragraph .11 of AU sec. 230, *Due Professional Care in the Performance of Work*.

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each requirement in the original proposed standards and has revised certain provisions in the new proposed standards to streamline the presentation of those requirements.

5. Use of Terms

PCAOB Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*, sets forth the terminology used by the Board to describe the degree of responsibility that the auditing and related professional practice standards impose on auditors. The original proposed standards used terms in its requirements in a manner that was consistent with Rule 3101.

Several comments received on the original proposed standards related to the use of certain terms in the requirements of the standards. For example, several comments related to matters for which the original proposed standards stated that the auditor "should evaluate," "should assess," or "should take into account," whereas the existing PCAOB standards state that the auditor "should consider," and the IAASB standards use the term "shall consider." Some commenters suggested that the original proposed standards should use the term "should consider." They also asked about the meaning of the phrase "take into account."

The Board has reviewed these comments and the requirements in the original proposed standards and made certain revisions in the new proposed standards. The new proposed standards, like the original proposed standards, use "should consider" only when referring to a requirement to consider performing an action or procedure, which is consistent with PCAOB Rule 3101. The phrase "take into account" is not new. It has been used previously in PCAOB standards in reference to information or matters that the auditor should think about or give attention to in performing an audit procedure or reaching a conclusion.^{5/} Accordingly, the results of the auditor's thinking on the relevant matters should be reflected in the performance and documentation of the respective audit procedure performed or conclusion reached.

6. Organization and Style of PCAOB Standards

Many commenters offered observations about the organization and style of the original proposed standards. They generally supported the practice of presenting an

^{5/} AU sec. 316.45 and paragraphs 14, 44, 59, and B 12 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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objective in each standard. Some commenters suggested that the Board adopt a consistent approach to the organization and style of its standards, including the location of definitions within the standards.

The organization and style of the new proposed standards draws from previously issued standards of the Board and will provide a template generally to be followed in the future standards issued by the Board. Like Auditing Standard No. 7, *Engagement Quality Review*, each new proposed standard has an objective. Like Auditing Standard No. 5, some of the new proposed standards include appendices for definitions and special topics.

Some commenters asked about the role of objectives, notes, and appendices in the Board's standards, and they observed that some notes and appendices appear to include requirements. The Board has included objectives in the new proposed standards to provide additional context for understanding the requirements in the respective standards. As with other PCAOB standards, the auditor's responsibilities for complying with the standards are communicated using the terms set forth in PCAOB Rule 3101. The notes and appendices in the Board's auditing standards are considered as integral parts of the standards.^{6/} Accordingly, the notes and appendices of the new proposed standards carry the same authoritative weight as the other portions of the new proposed standards.

7. Additional Discussion of Topics

Some commenters approved of the brevity of the original proposed standards, but they requested additional discussion of some specific topics. The Board has analyzed each of those requests and, in many instances, has added further explanation or examples in the new proposed standards. This Appendix discusses specific provisions that were added to the respective new proposed standards.

Question

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

^{6/} See Question Nos. 1 and 2 of *Staff Questions and Answers: Auditing Internal Control Over Financial Reporting* (June 23, 2004 and revised July 27, 2004).

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Proposed Auditing Standard – Audit Risk

1. Background

The new proposed standard discusses audit risk and the relationships among the various components of audit risk in an audit of financial statements as part of an integrated audit and an audit of financial statements only. The descriptions of the components of audit risk and their relationships are similar to the respective discussions in existing PCAOB standards.⁷¹

2. Objective of the Standard

The original proposed standard stated that the objective of the auditor is to conduct an audit of financial statements in a manner that reduces audit risk to an appropriately low level. This objective is retained without change from the original proposed standard.

A few commenters expressed concern that the objective in the original proposed standard was too broad because it related to the overall conduct of the audit. The Board believes that the objective of the standard is appropriate because it provides important context for understanding how the concept of audit risk is applied in an audit.

One commenter also suggested that the term, "...appropriately low level" should be revised to "...an acceptably low level." The Board believes the term "appropriately low level" is more suitable because it is aligned more closely with the degree of assurance expressed in the auditor's opinion, i.e., the auditor conducts the audit to reduce audit risk to an appropriately low level in order to express an opinion with reasonable assurance. In contrast, the term "acceptably low" could be misinterpreted as a matter of individual preference.

3. Due Professional Care and Sufficient Appropriate Audit Evidence

The original proposed standard stated that, to form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are

⁷¹ These concepts are discussed primarily in AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, and AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*.

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free of material misstatement due to error or fraud. It also stated that reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care and obtaining sufficient appropriate audit evidence.^{8/}

A commenter suggested that applying due professional care and obtaining sufficient appropriate audit evidence are related concepts and that the wording of the original proposed standard should be changed. The new proposed standard clarifies that obtaining sufficient appropriate audit evidence is part of applying due professional care.

4. Audit Risk and Risk of Material Misstatement

Although not mentioned in the comment letters, the Board believes that the original proposed standard could be enhanced by relating more clearly the concept of audit risk to the opinion expressed in the auditor's report. Thus, the new proposed standard states that audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, i.e., the financial statements are not presented fairly in conformity with the applicable financial reporting framework. Similarly, the new proposed standard states that the risk of material misstatement refers to the risk that the financial statements are materially misstated, i.e., the financial statements are not presented fairly in accordance with the applicable financial reporting framework.

These expanded descriptions of audit risk and the risk of material misstatement emphasize the auditor's responsibility to plan and perform the audit to assess and respond to risks that would cause the financial statements to be not presented fairly in accordance with the applicable financial reporting framework.

Some commenters suggested that the description of the risk of material misstatement should indicate that the risk exists "prior to audit" to more clearly indicate that it is the company's risk. The Board agrees that the risk of material misstatement exists irrespective of the audit, while the risk of not detecting material misstatement is the auditor's risk. However, adding the suggested phrase is unnecessary because the new proposed audit risk standard already indicates that the risk of material misstatement exists independently of the audit. Also, the suggested phrase could be

^{8/} See AU sec. 110, *Responsibilities and Functions of the Independent Auditor*, and AU sec. 230.

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misinterpreted, e.g., as implying that the auditor need not consider the risk of misstatements occurring during the audit.

Some commenters suggested adding more explanation about risks at the overall financial statement level, e.g., by providing examples of such risks. The new proposed standard is expanded to elaborate further on risks at the financial statement level.

5. Integrated Audit Considerations

This new proposed standard applies both to audits of financial statements only and to the financial statement audit portion of integrated audits. Some commenters expressed concern that the language in the first paragraph of the original proposed standard implied that there are two distinct processes for the auditor's consideration of risk in the individual portions of the integrated audit.

The language in the original proposed standard was intended to acknowledge that the objectives of the audit of the financial statements and the audit of internal control are different, so the components of audit risk are not identical. Audit risk in the audit of financial statements relates to whether the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, while audit risk in an audit of internal control relates to whether the auditor expresses an inappropriate audit opinion when one or more material weaknesses exist. The two forms of audit risk are related, however, and the Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, indicates that the risk assessment procedures required by that new proposed standard apply to both the audit of financial statements and the audit of internal control. Thus, the language of the new proposed standard on audit risk clarifies its nature and purpose.

6. Detection Risk

The original proposed standard indicated that detection risk is reduced by performing substantive procedures. Some commenters suggested that the discussion of detection risk be modified to indicate that auditors can reduce detection risk through procedures other than substantive procedures (e.g., risk assessment procedures and test of controls).

The Board acknowledges that auditors might obtain evidence of misstatements through procedures other than substantive procedures. However, that does not diminish the auditor's responsibility to perform substantive procedures for significant accounts

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and disclosures that are sufficient to provide reasonable assurance of detecting misstatements that would result in material misstatement of the financial statements. Furthermore, the changes suggested by the commenters are not consistent with existing PCAOB standards^{9/} and could be misunderstood by auditors, resulting in inadequate substantive procedures. However, the Board has made some revisions to clarify the discussion of detection risk in the new proposed standard.

Questions

2. Does the new proposed standard on audit risk describe clearly the concept of audit risk and its components?
3. Does the new proposed standard on audit risk describe clearly the relationship between detection risk and substantive procedures?

Proposed Auditing Standard – Audit Planning and Supervision

1. Background

This new proposed standard describes the auditor's responsibilities for planning the audit and supervising the work of engagement team members in integrated audits and audits of financial statements only. This new proposed standard would supersede AU sec. 311, *Planning and Supervision*.

2. Responsibilities of the Engagement Partner

Existing PCAOB standards state, "The auditor with final responsibility for the audit may delegate portions of the planning and supervision of the audit to other firm personnel."^{10/} The new proposed standard uses the term "engagement partner" instead of "auditor with final responsibility for the audit" and states more directly that the engagement partner is responsible for planning the audit and supervising other engagement team members. The new proposed standard allows the engagement partner to seek assistance from appropriate engagement team members in fulfilling his or her planning and supervision responsibilities. Because the requirements in the

^{9/} AU secs. 319.81-.82.

^{10/} Paragraph .02 of AU sec. 311, *Planning and Supervision*.

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standard apply to anyone who performs planning or supervision activities, the requirements in the standard use the term "auditor."

3. Requirement to Properly Plan and Supervise

The original proposed standard included a statement, following the objective of the standard, that the auditor must properly plan the audit and supervise members of the engagement team. Some commenters questioned the placement of the requirement after the objective. The new proposed standard was revised by (1) dividing the proposed requirement into separate requirements regarding planning and supervision and (2) placing those separate requirements into the respective sections of the new proposed standard. Some commenters also observed that Auditing Standard No. 5 has a similar requirement for planning and supervising the audit of internal control but uses the term "should" instead of "must." The requirements in the original proposed standard have been modified to use the term "should" to align with the corresponding requirement in paragraph 9 of Auditing Standard No. 5.

4. Planning Activities

The original proposed standard stated that, as part of establishing the audit strategy and audit plan, the auditor should evaluate whether certain matters specified in the standard are important to the company's financial statements and internal control over financial reporting ("internal control") and, if so, how they would affect the auditor's procedures. The requirement in the original proposed standard is the same as in paragraph 9 of Auditing Standard No. 5, thus extended its application to an audit of financial statements. Several commenters suggested removing the requirement from Auditing Standard No. 5. Other commenters suggested changes to the requirement, including deleting some of the matters discussed in the requirement, moving other matters elsewhere within the proposed standard, or including additional matters.

The Board considered the suggested changes to the original proposed standard and determined that those changes would not substantially improve the proposed standard. Also, the Board believes that it is important for the language in this requirement to be identical to the language in Auditing Standard No. 5 to emphasize that this required procedure is to be performed only once in an integrated audit, with the results of the procedure to be applied in planning both the financial statement audit and the audit of internal control.

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5. Requirements for Multi-location Engagements

The original proposed standard carried forward the existing requirements for multi-location engagements from AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, and Auditing Standard No. 5 with little change. Some commenters suggested that the requirements in the original proposed standard should be aligned more closely with Auditing Standard No. 5, e.g., by incorporating more provisions from Auditing Standard No. 5.

The Board agrees that aligning the multi-location requirements in the original proposed standard with those in Auditing Standard No. 5 would improve the original proposed standard and could facilitate better integration of the financial statement audit and the audit of internal control. The original proposed standard has been revised to align more closely with Auditing Standard No. 5 and to refine the provisions regarding consideration of risks in individual locations. For example, like Auditing Standard No. 5, the new proposed standard directs the auditor to take into account the risks associated with the location or business unit that present a reasonable possibility of material misstatement to the company's consolidated financial statements.

6. Persons with Specialized Skill or Knowledge

The original proposed standard included requirements to determine the need for specialized skill or knowledge to perform appropriate risk assessments, apply the planned audit procedures, or evaluate audit results. The original proposed standard generally retained requirements from AU sec. 311.10 and paragraphs .31-.32 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, related to the use of persons with information technology ("IT") skill or knowledge. However, the language in the original proposed standard was changed to expand the application to specialized skill or knowledge in areas besides IT, such as valuation specialists, actuarial specialists, and forensic specialists. Commenters generally agreed with this change but suggested that the original proposed standard include a list of examples of specialists that might be used in conducting an audit. A list of possible specialists was not added to the new proposed standard because the types of specialized skill or knowledge that might be needed on a particular audit depend on the particular circumstances and the skills and knowledge of the engagement team.

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The original proposed standard also included a requirement regarding the knowledge of the subject matter needed by an auditor who is working with a person^{11/} with specialized IT skill or knowledge. Some commenters suggested that this requirement should not be limited to situations involving only persons with specialized IT skill or knowledge. Some commenters also suggested that the original proposed standard should state that any specialist that functions as a member of the engagement team requires the same supervision as any other member of the engagement team.

The requirements in paragraphs 16-17 in the new proposed standard were revised to apply to situations in which a person with specialized knowledge or skill employed or engaged by the auditor participates in the audit. Paragraph 17 describes the required level of knowledge of the subject matter in terms of the general types of procedures that the auditor should be able to perform with regard to the person with specialized skill or knowledge. Paragraph 17, by itself, does not impose procedural requirements for working with persons with specialized skill or knowledge because those responsibilities already are described in either the supervision provisions of the new proposed standard or AU sec. 336, *Using the Work of a Specialist*, as applicable. Paragraphs 18-19 explain when the supervision requirements in the new proposed standard apply and when the requirements of AU sec. 336 apply.

Paragraph 18 states that the supervision requirements in the new proposed standard apply to supervision of a person with specialized skill or knowledge who participates in the audit and is either (a) employed by the auditor or (b) engaged by the auditor to provide services in a specialized area of accounting or auditing. This paragraph applies the supervision provisions of the new proposed standard to situations in which a person with specialized skill or knowledge participates in the audit, except for those situations that are covered by AU sec. 336. Paragraph 19 explains how the audit procedures listed in paragraph 17 are addressed in AU sec. 336.

Paragraphs 18-19 are intended to maintain the relationship between the standards for planning and supervision and the use of the work of specialists that currently exists in PCAOB standards. For example, AU sec. 336.05 is consistent with the principle that firms should be able to supervise their own employees who are specialists. It should be noted, however, that the Board has a separate standards-setting project regarding using the work of specialists. This project will include a

^{11/} Under PCAOB Rule 1001(p)(iv), the term "person" means any natural person or any business, legal or governmental entity or association.

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comprehensive review of AU sec. 336 and is likely to result in changes to the auditor's responsibilities regarding persons with specialized knowledge and skills, including changes to paragraphs 18-19 of the new proposed standard.

7. Supervision

The original proposed standard adapted the supervision requirements from AU sec. 311 with some conforming changes to align more closely with the other new proposed standards. Some commenters observed that the original proposed standard included requirements that were overlapping and redundant, and the new proposed standard has been revised to streamline the description of the supervision requirements.

The new proposed standard states that the auditor should properly supervise the engagement team members, i.e., the persons who participate in the audit. Existing PCAOB standards use either the term "engagement team members" or the term "assistants." This new proposed standard uses "engagement team members," which is consistent with the other new proposed standards.

The new proposed standard also describes the general elements of proper supervision of engagement team members by the engagement partner (and those who assist the engagement partner in supervision), which apply unless specified otherwise in PCAOB standards. For example, consistent with paragraph 19 of the new proposed standard, the auditor should look to the provisions of AU sec. 336 rather than the supervision provisions of the new proposed standard when using the work of specialists engaged by the auditor in accordance with AU sec. 336.

It should be noted that the Board has other standards-setting projects that are likely to result in future revisions of the provisions of the new proposed standard. For example, the Board has a separate standards-setting project regarding using the work of specialists, which will involve a comprehensive review of AU sec. 336 and the auditor's responsibilities regarding persons with specialized knowledge and skills.

8. Differences of Opinion within an Engagement Team

The original proposed standard included a requirement, adapted from AU sec. 311.14, that the engagement partner and other engagement team members should make themselves aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among the engagement team members.

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Some commenters questioned how they would demonstrate compliance with a requirement to make themselves aware of the matters described in the standard.

Since the intention of including this provision was to require adequate documentation of disagreements, this paragraph has been removed from the new proposed standard, and the documentation requirements from the original proposed standard have been incorporated into an amendment of Auditing Standard No. 3, *Audit Documentation*.^{12/}

Questions

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

Proposed Auditing Standard – Consideration of Materiality in Planning and Performing an Audit

1. Background

This proposed standard sets forth the auditor's responsibilities for applying the concept of materiality, as described by the federal securities laws, in planning the audit and determining the scope of the audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements. It would apply to integrated audits and audits of financial statements only.

^{12/} Paragraph 12.d. of Auditing Standard No. 3, *Audit Documentation*.

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2. Materiality in the Context of an Audit

The original proposed standard discussed the concept of materiality as described in the financial reporting frameworks and included an example from Financial Accounting Standards Board ("FASB") Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*. Subsequent to the issuance of the original proposed standard, the FASB has published its accounting standards codification, which does not include the FASB Concepts Statements.

More importantly, although the discussion of materiality in applicable financial reporting frameworks might help readers understand how accounting standard setters view materiality in the context of preparation and presentation of financial statements, the concept of materiality that applies to audits of issuers is that used by the courts 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." (TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).) Accordingly, the requirement in the new proposed standard regarding how the auditor should determine materiality is based on the courts' articulation of the concept of materiality, and the discussion of financial reporting frameworks has been removed.

3. Establishing a Materiality Level for the Financial Statements as a Whole

The original proposed standard indicated that the auditor should establish an appropriate materiality level for the financial statements as a whole. This materiality level should be established in light of the particular circumstances. For example, if a company's net earnings were the most important factor in the total mix of information available to a reasonable investor, then the company's earnings should be taken into account in establishing the materiality level for the financial statements taken as a whole. On the other hand, financial statement elements other than net earnings might be more important to a reasonable investor depending on the company's industry or operations, e.g., if the company has minimal net income or loss. Accordingly, the new proposed standard states that establishing materiality for the financial statements as a whole includes consideration of the company's earnings and other relevant factors. Observations from the Board's oversight activities have included instances in which firms have determined materiality levels using methods that do not consider elements of the financial statements that may be important to reasonable investors.

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The original proposed standard also included a statement that, when planning the audit, the auditor's materiality level for the financial statements as a whole needs to be expressed as a specified amount. This statement reflects the fact that, as a practical matter, many of the auditor's decisions involving planning the scope of the audit are quantitative, e.g., decisions about the number of items to be selected in performing a substantive audit procedure.

Some commenters on this section of the original proposed standard suggested adding further explanation on how to establish a materiality level for the financial statements as a whole. Some of those commenters suggested certain quantitative guidelines that might be used to establish a materiality level. The new proposed standard does not contain additional provisions regarding establishing a materiality level for the financial statements. The concept of materiality is already articulated by the courts. That concept reflects the perspective of a reasonable investor and is necessarily dependent on the particular circumstances. The Board does not prescribe particular quantitative guidelines in establishing materiality levels nor prohibit the use of quantitative guidelines, as long as the guidelines are consistent with the perspective of a reasonable investor and appropriate in light of the particular circumstances.

4. Qualitative Considerations

The concept of materiality involves consideration of both quantitative and qualitative factors. Under the original proposed standard and the new proposed standard, qualitative considerations can affect the auditor's establishment of materiality levels in the following ways:

- Establishing a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This involves matters such as consideration of the elements of the financial statements that are more important to a reasonable investor and level of misstatements that would influence the judgment of a reasonable investor.
- Establishing lower levels of materiality for certain accounts or disclosures when, 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. The formulation in the proposed standard is consistent with the principle of considering the perceptions of investors when making

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materiality judgments because it recognizes that, in certain circumstances, misstatements in some accounts might have more significant consequences than in other accounts. The following are a few examples of situations in which a lower materiality threshold might be needed:

- Laws, regulations, or the applicable financial reporting framework affect investors' expectations about the measurement or disclosure of certain items, e.g., related party transactions and compensation of senior management.
- Significant attention has been focused on a particular aspect of a company's business that is separately disclosed in the financial statements, e.g., a recent business acquisition.
- Certain disclosures are particularly important to investors in the industry in which the company operates.

The new proposed standard does not allow the auditor to establish a materiality level for an account or disclosure at an amount that exceeds materiality for the financial statements as a whole.

The original proposed standard included the statement, adapted from existing PCAOB standards, that auditors should be alert for misstatements that are material based on qualitative factors, but ordinarily it is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors.^{13/} One commenter expressed a concern about how an auditor would demonstrate that he or she was alert for misstatements that might be material for qualitative reasons. Another commenter expressed a concern that statement was placed in a note rather than in the body of the paragraph. This statement was moved to the body of the paragraph and revised to clarify that being alert for misstatements that could be material for qualitative reasons is part of the overall requirement to plan and perform the audit to detect misstatements that would, individually or in combination, result in material misstatement of the financial statements. Some commenters suggested removing the word "ordinarily" from the statement that "it ordinarily is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors." Another commenter stated that it is possible to design audit procedures to

^{13/} AU sec. 312.20.

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detect such misstatements. The new proposed standard retains the statement that ordinarily it is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors. This statement reflects the principle that judgments about whether a particular misstatement is material involve consideration of the particular circumstances, including the nature of the misstatement and its effect on the financial statements. Also, if an auditor is aware of potential misstatements that would be material based on qualitative factors, he or she has a responsibility to design audit procedures to detect such misstatements.

Commenters on these provisions of the standard also recommended that the Board revise the language of the standard to replace references to "reasonable investor" with "user," because Auditing Standard No. 5 refers to users of the auditor's report and because other parties besides investors might use the audited financial statements. The new proposed standard continues to use the term "reasonable investor" to align with the articulation used by the courts.

5. Tolerable Misstatement and Performance Materiality

The original proposed standard included requirements for the auditor to determine tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level. Tolerable misstatement is a concept used in determining the scope of audit procedures. Paragraph .18 of AU sec. 350, *Audit Sampling*, indicates that tolerable misstatement is the maximum amount of misstatement in an account or a class of transactions that may exist without causing the financial statements to be materially misstated. Tolerable misstatement is required to be set at an amount less than the materiality level for the financial statements and, if applicable, for particular accounts or disclosures.

Some commenters suggested replacing the term "tolerable misstatement" in the original proposed standard with the term "performance materiality," primarily because the latter term is used in the International Standards on Auditing ("ISAs"). One commenter recommended retaining the term "tolerable misstatement" because it is already well understood by auditors.

The Board decided to retain the term "tolerable misstatement" in its standards. That concept is already understood by auditors, and the Board is not seeking to change the concept as described in existing PCAOB standards. Also, tolerable misstatement necessarily reflects an auditor perspective because it considers the potential undetected

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misstatement in the accounts and disclosures, whereas materiality, as used in the new proposed standard, reflects a reasonable investor's perspective. Also, since the new term "performance materiality" contains the word "materiality," it could be misunderstood, e.g., by non-auditors, as having a meaning other than that intended in the new proposed standard.

6. Consideration of Materiality for Multi-location Engagements

The release accompanying the original proposed standards specifically sought comment on whether the standard should specifically address consideration of materiality in multi-location engagements. One commenter suggested that the standards should address materiality considerations in multi-location engagements.

The Board agrees that specific provisions regarding materiality determinations in multi-location engagements would be appropriate because of the importance of those determinations to the scope of testing at individual locations. The Board added a new paragraph to the new proposed standard, which states –

For purposes of the audit of the consolidated financial statements of a company with multiple locations or business units, the auditor should establish the materiality level to be used in performing audit procedures at the locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements. Accordingly, materiality at an individual location cannot exceed, and generally should be less than, materiality for the financial statements as a whole.

This requirement is an application of the fundamental principles in the new proposed standard to audits of consolidated financial statements of companies with multiple business units or locations. For example, if the auditor plans to perform procedures at selected locations or business units, the auditor generally should establish the materiality level for the selected locations or business units to be lower than the materiality level for the consolidated financial statements to allow for the possibility that uncorrected and undetected misstatements in the selected locations or business units and potential undetected misstatements in untested locations or business units could exceed the materiality level for the consolidated financial statements.

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7. Reassessing Materiality

The original proposed standard required the auditor to reassess the established materiality level or levels and tolerable misstatement in certain situations specified in the standards, which relate to the changes in the financial statement amounts upon which the materiality level or levels were based. This requirement recognizes that the materiality levels used in planning and performing the audit often are based initially on estimated financial statement data and reassessed when year-end financial statement data becomes available or when the financial statements are adjusted significantly.

Although not specifically addressed in comment letters, the Board believes that this requirement should be revised to reflect the broader principle that the materiality and tolerable misstatement should be reassessed if changes in the particular circumstances or additional information come to the auditor's attention that is likely to affect the judgments of a reasonable investor. This principle would encompass the situations described in the preceding paragraph as well as other situations, such as the following:

- Changes in laws, regulations, or the applicable financial reporting framework affect investors' expectations about the measurement or disclosure of certain items.
- Significant new contractual arrangements have attracted attention on a particular aspect of a company's business that is separately disclosed in the financial statements.

The reassessment of materiality is important because if that reassessment results in a lower amount for the materiality level or levels or tolerable misstatement than the auditor's initial determination, the auditor should (1) evaluate the effect, if any, of the lower amount or amounts on his or her risk assessments and audit procedures and (2) modify the nature, timing, and extent of audit procedures as necessary to obtain sufficient appropriate audit evidence.

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

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

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?

Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement

1. Background

This new proposed standard describes the auditor's responsibilities for the process of identifying and assessing risks of material misstatement in an audit of financial statements only and in an integrated audit. This process includes performing (1) information-gathering procedures, known as "risk assessment procedures," and (2) identifying and assessing the risks of material misstatement using information obtained from the risk assessment procedures.

This new proposed standard brings together requirements from certain existing PCAOB standards,^{14/} adds new provisions regarding certain risk assessment procedures, and sets forth a new process for assessing those risks, including the determination of significant risks.

2. Objective of the Auditor

The original proposed standard stated that the objective of the auditor was to identify and appropriately assess the risks of material misstatement. Several commenters stated that the objective did not establish the necessary linkage between identifying and assessing the risks of material misstatement and responding to those risks. The Board agrees that proper linkage between the auditor's risk assessments and responses is essential to an effective risk-based audit, so the objective in the new proposed standard indicates that the auditor's risk assessments provide a basis for the auditor's response.

^{14/} Those standards include AU sec. 311, AU sec. 312, AU sec. 316, AU sec. 319, AU sec. 329, *Substantive Analytical Procedures*, and Auditing Standard No. 5.

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3. Top-down Approach

Some commenters suggested that the original proposed standard should specifically direct the auditor to use a top-down approach, as Auditing Standard No. 5 requires for the audit of internal control.

The Board agrees that a top-down approach should be used in identifying and assessing the risks of material misstatement. Such an approach 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. The process described in the original proposed standard is a top-down approach, so adding a specific requirement to apply a top-down approach is unnecessary. Instead, the new proposed standard contains a note that emphasizes the use of a top-down approach.

4. Size and Complexity of the Company

The size and complexity of the company can affect the risks of misstatement and the controls necessary to address those risks. Scaling the audit is most effective as a natural extension of the risk-based approach and applies to all audits. The procedures in the new proposed standard are designed to be scalable to companies of varying size and complexity. Although some commenters indicated that the original proposed standard is appropriately scalable, other commenters suggested that the original proposed standard should explain how the size and complexity of the company affects the risk assessment process. Certain notes have been added to the new proposed standard to discuss scaling the audit based on a company's size and complexity.

5. Risk Assessment Procedures

Under the new proposed standard, the overarching requirement for risk assessment procedures is that 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 and to design further audit procedures.^{15/} The new proposed standard also discusses the auditor's responsibilities

^{15/} The phrase "design further audit procedures" applies to substantive procedures and to tests of controls in the audit of financial statements and the audit of internal control over financial reporting.

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for determining and performing the risk assessment procedures necessary to satisfy that overarching requirement.

Risks of material misstatement may exist at the financial statement level or at the assertion level. Risks of material misstatement also 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. Since the risks of material misstatement come from various sources, the auditor's risk assessment procedures need to encompass both external factors and company-specific factors. The new proposed standard requires risk assessment procedures related to the following areas:

- Obtaining an understanding of the company and its environment;
- Obtaining an understanding of the company's internal control;
- Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company;
- Performing analytical procedures;
- Conducting a discussion among engagement team members; and
- Inquiring of the audit committee, management, and others within the company.

The new proposed standard's risk assessment procedures are designed to help the auditor identify the areas of greater risk so the auditor can design and perform audit procedures to address those risks. For example, a company's financial statements could be susceptible to misstatement because of lack of financial reporting competencies of company personnel, failures in information systems to accurately capture business transactions, or inadequate alignment between financial reporting processes and the requirements in the accounting standards. The following provisions of the new proposed standard, among others, could lead to identification of the sources of potential misstatements in those situations, along with the accounts or disclosures that could be affected:

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- Understanding the selection and application of accounting principles, including, among other things –
 - Significant changes in the company's accounting principles, financial reporting policies, or disclosures and the reasons for such changes,
 - The methods the company uses to account for significant and unusual transactions,
 - The accounts or disclosures in which judgment is used in the application of significant accounting principles,
 - The financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles,
 - Financial reporting standards, laws, and regulations that are new to the company and when and how the company will adopt such requirements (paragraph 12),
- Obtaining an understanding of the procedures, within both automated and manual systems, by which transactions are initiated, authorized, processed, recorded and reported (paragraph 28),
- Understanding the company's objectives, strategies, and relevant business risks (paragraph 14),
- Understanding the sources of the company's earnings (paragraph 10), and
- Evaluating whether significant changes in the company from prior periods, including changes in its internal control, affect the risks of material misstatement (paragraph 8).

Similarly, if external or company-specific factors create pressures to manipulate the financial statements to achieve certain financial targets, the following are examples of provisions in the new proposed standard that could lead to identification of those incentives or pressures and the accounts or disclosures that are most susceptible to misstatement:

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- Understanding the nature of the company, including –
 - Sources of funding of the company's operations and investment activities,
 - The company's significant investments including equity method investments, joint ventures, and variable interest entities (paragraph 10),
- Reading public information about the company (paragraph 11),
- Observing or reading transcripts of earnings calls (paragraph 11),
- Obtaining an understanding of compensation arrangements with senior management (paragraph 11),
- Obtaining information about trading activities in the company's securities and holdings by significant holders in the company's securities (paragraph 11),
- Obtaining an understanding of relevant performance measures (paragraph 16),
- Understanding the company's selection and application of accounting principles, including the accounts or disclosures in which judgment is used in the application of significant accounting principles, especially in determining management's estimates and assumptions (paragraph 12),
- Conducting a brainstorming session about ways in which the financial statements could be manipulated (paragraph 46), and
- Performing analytical procedures to identify unexpected trends or relationships that could present risks of material misstatement (paragraphs 43).

Some commenters expressed a view that the original proposed standard contained duplicative and prescriptive requirements, limiting the auditor's ability to use professional judgment and to scale the audit. For example, the commenters observed

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that the original proposed standard on identifying and assessing risks of material misstatement had more requirements than the related IAASB standard.

Because of the importance of the auditor's risk assessments to an effective risk-based audit, the Board believes that the standard must contain rigorous requirements for performing risk assessment procedures and assessing the risks of material misstatement. However, in light of the comments received, the Board has re-examined each unconditional or presumptively mandatory responsibility in the proposed standard and has revised certain provisions of the original proposed standard to streamline the description of the requirements and to clarify certain other provisions.^{16/}

6. Obtaining an Understanding of the Company and its Environment

The new proposed standard requires the auditor to obtain an understanding of the company and its environment to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. The requirements in the original proposed standard were an expansion of the requirements in AU sec. 311.06-.09 on obtaining knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics as part of audit planning. The expansion of the requirements is important because existing standards do not focus sufficiently on the degree of knowledge of the company that is necessary for a risk-based audit or explain how that knowledge informs the auditor's identification and assessment of risk.

The necessary understanding of the company and its environment includes understanding the following:

- Relevant industry, regulatory, and other external factors;
- The nature of the company;
- The company's selection and application of accounting principles;
- The company's objectives and strategies and those related business risks that might reasonably be expected to result in risks of material misstatement; and

^{16/} Examples of provisions of the new proposed standard that have been revised include paragraphs 7, 11, 12, 20, and 24.

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- The company's measurement and review of its financial performance.

The new proposed standard then explains each of those aspects of the company and its environment. The discussion of relevant industry, regulatory, and other external factors is adapted from AU sec. 311. The discussion of the nature of the company is also adapted from AU sec. 311 and has been updated to reflect certain changes in business practices since the existing standard was originally issued (e.g., to encompass alternative investments and financing arrangements and to recognize the development of new business models).

Existing PCAOB standards recognize that financial reporting risks can arise due to circumstances such as changes in operating environment; new personnel; new or revamped information systems; rapid growth; new technology; new business models, products, or activities; corporate restructurings; expanded foreign operations; and new accounting pronouncements.^{17/} The original proposed standard specifically required, and the new proposed standard continues to require, the auditor to evaluate the effect of significant changes in the company from prior periods, including changes in internal control, on the risks to the financial statements. Commenters suggested that this requirement be expanded further to take account of significant ongoing matters. The commenters' suggested revision is reflected in a subsequent provision of the new proposed standard regarding consideration of matters noted in past audits in paragraphs 39-40.

Additional Procedures to Obtain an Understanding of the Company and its Environment

The original proposed standard presented a list of additional procedures that the auditor should consider performing as part of obtaining an understanding of the company and its environment related to reading public information about the company, observing or reading transcripts of earnings calls, obtaining an understanding of compensation arrangements with senior management, and obtaining information about significant unusual developments regarding trading activity in the company's securities.

Members of the Board's Standing Advisory Group ("SAG")^{18/} suggested that these matters could provide valuable information for identifying risks of material

^{17/} AU sec. 319.38.

^{18/} February 16, 2005. Webcasts of SAG meetings are available on the Board's website at www.pcaobus.org/News_and_Events/Webcasts.

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misstatement in many audits of issuers, e.g., to obtain information about business risks relevant to financial reporting or to identify incentives or pressures on management to manipulate financial results. Also, the Public Oversight Board, *Panel on Audit Effectiveness, Report and Recommendations* ("PAE Report"), recommended that auditors consider published analysts' reports and forecasts when gaining an understanding of the company's business and industry, assessing risks, and evaluating identified misstatements.^{19/} The Board believes that these procedures can provide important information on many audits, so the new proposed standard establishes a responsibility for auditors to consider performing these procedures in each audit. The auditor's decisions about whether to perform one or more of the additional procedures should be informed by whether the matters addressed in those procedures are important to the company's internal control or financial statements^{20/} and whether such procedures are necessary to meet the overall requirements for obtaining an understanding of the company and performing risk assessment procedures.^{21/}

Some commenters expressed concerns about the practicality of the procedures for reading public information and understanding unusual trading activity. The new proposed standard includes revised language and examples to clarify the intent of those procedures. Also, the provision regarding observing or reading transcripts of earnings calls has been expanded to include, if publicly available, other meetings with investors or rating agencies, since those other meetings could also provide relevant information.

Selection and Application of Accounting Principles

PCAOB standards require auditors to obtain an understanding of the accounting practices common to the industry and to evaluate the quality of a company's accounting principles as part of his or her response to fraud risks and in determining matters to be communicated to the audit committee.^{22/} The new proposed standard imposes a responsibility to obtain an understanding of the applicable financial reporting framework and to evaluate whether the company's selection and application of accounting

^{19/} Public Oversight Board, *Panel on Audit Effectiveness, Report and Recommendations* ("PAE Report") (August 31, 2000), p. 58.

^{20/} See paragraph 9 of Proposed Auditing Standard, *Audit Planning and Supervision*.

^{21/} See paragraphs 4 and 7 of the new proposed standard.

^{22/} See AU sec. 316 and AU sec. 380, *Communication with Audit Committees*.

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principles is consistent with the applicable accounting framework and the accounting principles used in the relevant industry. Such procedures can provide important information for identifying relevant matters such as (1) accounts that are susceptible to misstatement, e.g., if an account balance is determined using accounting principles that are inconsistent with the applicable financial reporting framework or (2) more general conditions that affect risks of material misstatement, e.g., if the company's selection or application accounting principles is more aggressive than the relevant industry.

The new proposed standard also presents a list of matters that, if present, are relevant to the necessary understanding of the company's selection and application of accounting principles. The amount of auditor attention devoted to an individual matter would depend on its importance in meeting the overall requirements for obtaining an understanding of the company and performing risk assessment procedures.^{23/}

The new proposed standard includes a new requirement to identify the necessary disclosures for the company's financial statements. This provision is not intended to require the auditor to evaluate the company's disclosures as part of the risk assessment process. Instead, it would require the auditor to develop expectations about the types of disclosures that would be necessary based on the information obtained about the company and its industry. This requirement should prompt auditors to be more thoughtful and thorough in their approach to testing and evaluating disclosures.

Company Objectives, Strategies, and Related Business Risks

The new proposed standard would require the auditor to obtain an understanding of the company's objectives, strategies, and related business risks in order to identify those business risks that could result in material misstatement of the financial statements, which the ISAs also require. The *PAE Report* recommended that auditors be required to obtain an understanding of the company's business risks.^{24/} The new proposed standard provides examples of business risks that might result in a risk of material misstatement of the financial statements. Auditors would need to consider the business risks that are relevant to the particular company and industry.

^{23/} See paragraphs 4 and 7 of the new proposed standard.

^{24/} See *PAE Report*, p. 20.

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Company Performance Measures

The risk assessment procedures required by the original proposed standard included obtaining an understanding of the company's performance measures. The purpose of obtaining that understanding is to identify those performance measures, whether external or internal, that affect the risks of material misstatement. For example, understanding performance measures can help the auditor to identify accounts or disclosures that might be susceptible to manipulation to achieve certain performance targets (or to conceal failures to achieve those targets) or to understand how management uses performance measures to monitor risks affecting the financial statements.

Some commenters asked for clarification regarding the list of examples of relevant performance measures in the original proposed standard, particularly the example of measures used in monitoring controls. After reviewing the comments, the Board included another example relating to external performance measures and clarified how the monitoring controls example relates to financial statement risks.

7. Obtaining an Understanding of Internal Control Over Financial Reporting

The new proposed standard describes the auditor's responsibilities regarding obtaining an understanding of internal control over financial reporting ("understanding of internal control"). Although the auditor's primary focus is on internal control over financial reporting, the new proposed standard also indicates that the auditor may obtain an understanding of controls related to operations or compliance objectives if they pertain to data the auditor plans to use in applying auditing procedures. These requirements are, in substance, equivalent to those in AU sec. 319, but the language has been revised to align more clearly with Auditing Standard No. 5.

The new proposed standard sets forth certain principles regarding the sufficiency of the auditor's understanding of internal control. The new proposed standard requires the auditor to obtain a sufficient understanding of each component of internal control to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures. The new proposed standard also indicates that the nature, timing, and extent of procedures necessary to obtain an understanding of internal control depend on the size and complexity of the company; the auditor's existing knowledge of the company's internal control; the nature of the company's internal controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the

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company's documentation of its internal control. For example, the auditor's procedures to obtain an understanding of internal control would be more extensive when the auditor plans to test controls more extensively (e.g., in an integrated audit), the company's internal control is more complex, or the company's controls have changed significantly.

Like the Board's existing standards,^{25/} the new proposed standard indicates that the understanding of internal control includes evaluating the design of controls and determining whether the controls are implemented. In accordance with the principles in the new proposed standard, the amount of audit attention devoted to design and operating effectiveness will vary based on the auditor's plan for testing controls. For example, if the auditor plans to test controls, more attention should be devoted to controls that the auditor plans to test.

Description of Internal Control Components

To describe the auditor's responsibilities for obtaining an understanding of internal control, it was necessary to describe the components of internal control. The components described in the proposed standard are similar to those used in the Board's existing standard, AU sec. 319. However, auditors may use other suitable recognized frameworks^{26/} in accordance with the provisions of the new proposed standard. If the auditor uses a suitable, recognized internal control framework with components that differ from those in the new proposed standard, the auditor should adapt the requirements in the new proposed standard to conform to the components in the framework used.

Control Environment

The Board's existing standard requires the auditor to consider the collective effect on the control environment of strengths and weaknesses in the various control environment factors.^{27/} The new proposed standard requires the auditor to assess the following matters as part of obtaining an understanding of the control environment:

^{25/} AU sec. 319.58.

^{26/} See Securities Exchange Act Release No. 34-47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

^{27/} AU sec. 319.35-.36.

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- Whether management's philosophy and operating style promote effective internal control;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

This new requirement in the new proposed standard is aligned more clearly with the requirements in Auditing Standard No. 5 for evaluating the control environment. However, the Board does not expect that the auditor's process for assessing the control environment in an audit of financial statements only to be the same as that required when expressing an opinion on internal control. For audits of financial statements only, the new proposed standard allows the auditor to base his or her assessment on evidence obtained as part of obtaining an understanding of the control environment and other relevant knowledge possessed by the auditor.

Because of the importance of the control environment to effective internal control, both the original proposed standard and the new proposed standard include a new requirement, which provides that if the auditor identifies a control deficiency in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor.

Understanding of Information System Relevant to Financial Reporting

The new proposed standard would expand the auditor's responsibility for obtaining an understanding of the information system relevant to financial reporting in two respects. First, the new proposed standard requires the auditor to obtain an understanding about relevant business processes relating to financial reporting. This was also a recommendation in the PAE Report^{28/} and is necessary for the auditor to understand the how the information system processes the company's transactions. The new proposed standard also discusses determining relevant business processes.

^{28/} PAE Report, p. 15.

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Second, the new proposed standard expands the requirements for understanding the period-end financial reporting process^{29/} by describing important elements of that process. Because that process is a common source of potential misstatements, the Board believes that it is important for the auditor to have an adequate understanding of the aspects of the period-end financial reporting process in all audits, including audits of financial statements only. However, the new proposed standard requires the auditor only to obtain an understanding of the process, whereas Auditing Standard No. 5 requires the auditor also to evaluate that process in the audit of internal control.

Management's Risk Assessment Process

The original proposed standard required the auditor to obtain an understanding of management's risk assessment process. After reviewing those requirements, the Board has added another requirement to obtain an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks. This requirement was added so that the auditor's risk assessments can be appropriately informed by management's risk assessments and the controls intended to address the risks.

Control Activities

Existing PCAOB standards describe the auditor's responsibilities for obtaining an understanding of control activities as a two-step process: (1) obtaining an understanding of control activities in connection with understanding the other internal control components and (2) obtaining a further understanding of controls if necessary to plan the audit.^{30/} The new proposed standard revises this requirement by referring to obtaining an understanding of control activities as necessary to meet the overall requirement for understanding internal control. As under existing PCAOB standards, a more extensive understanding of control activities is needed in areas in which the auditor plans to test controls.

The original proposed standard included a note stating, "For purposes of evaluating the effectiveness of internal control, the auditor's understanding of control

^{29/} AU sec. 319.49. The existing standard uses the term "financial reporting process used to prepare the entity's financial statements" but the proposed standard uses the same term as Auditing Standard No. 5.

^{30/} AU sec. 319.42.

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activities encompasses a broader range of accounts and disclosures than that which is normally obtained in an audit of financial statements only." Some commenters expressed concerns about whether the note was consistent with Auditing Standard No. 5 and suggested that the note be removed. The note has been removed.

Entity-level Controls

The original proposed standard on identifying and assessing risks required the auditor to obtain an understanding of the company's control environment and other components of internal control that are often entity-level controls.

Some commenters indicated that the original proposed standard did not place enough emphasis on entity-level controls and suggested that the paragraphs in Auditing Standard No. 5 related to the evaluation of entity-level controls should be included in the original proposed standard.

The requirement in Auditing Standard No. 5 to test those entity-level controls in the audit of internal control has a different objective from the objective for risk assessment procedures in general or for obtaining an understanding of internal control in particular. The Board believes that it is important for PCAOB standards to distinguish those two objectives, e.g., for auditors who are performing audits of financial statements only. On the other hand, the Board recognizes that evidence obtained while gaining an understanding of internal controls should be taken into account as part of the auditor's evaluation of the effectiveness of the controls and that obtaining an understanding of a control can be performed concurrently with testing it. Thus, the new proposed standard contains additional paragraphs discussing the relationship between obtaining an understanding of controls and testing controls, including testing entity-level controls.

8. Information Obtained in Other Engagements

The original proposed standard required the auditor to "assess whether information obtained in other engagements performed by the auditor is likely to be important in identifying risks of material misstatement." This requirement was intended to complement a requirement in the original proposed standard on audit planning and supervision to evaluate whether knowledge obtained during other engagements performed by the auditor is important to the company's financial statements and internal control and, if so, how it would affect the auditor's procedures.

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The requirement in the original proposed standard on identifying and assessing risks carries forward the existing requirement for the engagement team to take into account relevant information obtained from other engagements performed by the firm for the company. Examples of such engagements include permissible tax services performed for the company and statutory audits of subsidiaries that are not part of the audit of the consolidated financial statements.

Some commenters suggested that the requirement should be limited to consideration of other engagements performed by the engagement partner. Some of those commenters indicated that in a large global audit, it is not practical to expect the auditor to assess information obtained on all engagements performed by the audit firm for the company. Additionally, some commenters expressed concern that the requirement in the original proposed standard could be misinterpreted to mean engagements for other clients.

The Board believes that the suggested change would weaken the new proposed standard. Limiting the consideration of information to engagements performed for the company by the engagement partner is too narrow because it omits other important information sources that are available to the engagement team. Also, limiting the consideration to engagements performed by the engagement partner is inconsistent with existing PCAOB standards.^{31/} For example, AU sec 311.04 states that procedures the auditor may consider in planning an audit usually involve discussions with other firm personnel, and the standard includes the following example "Discussing matters that may affect the audit with firm personnel responsible for non-audit services to the entity." Also, paragraph 03 of AU sec. 9311, *Planning and Supervision: Auditing Interpretations of Section 311*, states –

The auditor should consider the nature of non-audit services that have been performed. He should assess whether the services involve matters that might be expected to affect the entity's financial statements or the performance of the audit, for example, tax planning or recommendations on a cost accounting system. If the auditor decides that the performance of the non-audit services or the information likely to have been gained

^{31/} PCAOB Rule 1001, *Definitions of Terms Employed in Rules*, states that, when used in rules of the PCAOB, unless the context otherwise requires, "The term 'auditor' means both public accounting firms registered with the Public Company Accounting Oversight Board and associated persons thereof."

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from it may have implications for his audit, he should discuss the matter with personnel who rendered the services and consider how the expected conduct and scope of his audit may be affected. In some cases, the auditor may find it useful to review the pertinent portions of the work papers prepared for the non-audit engagement as an aid in determining the nature of the services rendered or the possible audit implications.

The new proposed standard requires the auditor to take into account relevant information obtained through other engagements performed by the auditor for the company. This requirement is intended to focus on the responsibility to take relevant information into account in identifying and assessing risks rather than to prescribe a particular method for obtaining that information.

9. Performing Analytical Procedures as Risk Assessment Procedures

The new proposed standard retains the requirements and direction from AU sec. 329, *Analytical Procedures*, regarding performing analytical procedures during the planning phase of the audit. Such analytical procedures are, in essence, risk assessment procedures, so the respective requirements and direction have been incorporated into the new proposed standard.

10. Conducting a Discussion among Engagement Team Members Regarding Risks of Material Misstatement

AU sec. 316 requires a discussion among engagement team members about fraud risks. The new proposed standard extends this requirement to cover risks of material misstatement due to error or fraud.

A discussion among engagement team members about the risks of material misstatement is intended to:

- Provide an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the company;
- Allow the engagement team members to exchange information about the business risks affecting the company and about how those risks could result in material misstatement due to fraud or error;

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- Help engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing, and extent of further audit procedures; and
- Provide a basis upon which engagement team members can communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

Through its inspections program, the Board has observed deficiencies relating to discussion among engagement team members regarding fraud risks,^{32/} including instances in which key engagement team members did not participate. Since the engagement team discussion would be expanded to cover all risks of material misstatement, the Board evaluated whether the direction in AU sec. 316 could be enhanced to improve performance in this area. The Board decided to modify the formulation regarding the participation in the engagement team discussion to state more directly that the key engagement team members should participate in the discussion and to explain that key engagement team members include the engagement partner and all engagement team members who have significant engagement responsibilities. The term "significant engagement responsibilities" should be familiar to auditors because it is already used in AU sec. 316 regarding the appropriate assignment of engagement team members in the overall responses to fraud risks. The new proposed standard also contains additional direction regarding multi-location engagements.

The new proposed standard extends the requirements for the discussion about fraud risks by adding two discussion topics: (1) how fraud could be perpetrated or concealed by omitting or presenting incomplete disclosures and (2) the susceptibility of the financial statements to material misstatement through related party transactions. Past cases of fraudulent financial reporting have involved related party transactions and omitted or incomplete disclosures.

^{32/} PCAOB Release 2007-001, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud* (January 22, 2007).

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11. Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

AU sec. 316.24 includes a requirement to inquire of others within the entity about the existence or suspicion of fraud. That standard also presents examples of others within the entity to whom these inquiries should be directed. The original proposed standard expanded on this requirement by adding inquiries of accounting and financial personnel regarding:

- The employee's views as to whether accounting policies were appropriately or aggressively applied;
- The employee's views about the risks of fraud;
- Whether the employee has knowledge of fraud, alleged fraud, or suspected fraud affecting the company; and
- Whether the employee is aware of instance of management override of controls and the nature and circumstances of such overrides.

The original proposed standard included an additional inquiry of management regarding management's process for identifying and responding to the risks of fraud in the company, including any specific fraud risks the company has identified or account balances or disclosures for which a fraud risk is likely to exist, and the nature, extent, and frequency of management's fraud risk assessment process.

Commenters were supportive of the inquiries required of management, the audit committee, and internal audit. However, some commenters described the requirement to inquire of accounting and financial personnel as being too onerous, especially in a large multi-location entity. They were concerned that the requirement might involve an unnecessarily large number of company personnel without a corresponding benefit to the audit process. The language in the new proposed standard was revised to follow the language in AU sec. 316 more closely.

Like the original proposed standard, the new proposed standard includes an additional required inquiry of the internal auditor about whether he or she is aware of instances of management override of controls and the nature and circumstances of such overrides. Also, the new proposed standard requires the auditor to make inquiries of management and the audit committee regarding tips or complaints about the

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company's financial reporting. In light of research indicating that many incidents of fraud are uncovered through tips,^{33/} this inquiry could provide important evidence about fraud risks.

12. Identifying and Assessing Risks of Material Misstatement

The proposed standard sets forth a process for identifying and assessing the risks of material misstatement using the information obtained from the risk assessment procedures and other relevant knowledge possessed by the auditor.^{34/} This process involves:

- a. Identifying risks of misstatement due to error or fraud using information obtained from the risk assessment procedures and considering the characteristics of the accounts and disclosures in the financial statements.
- b. Evaluating whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions.
- c. Evaluating the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected. This includes evaluating how risks at the financial statement level could affect risks at the assertion level.
- d. Assessing 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. In making this assessment, the auditor may take

^{33/} See, e.g., Association of Certified Fraud Examiners, *2008 Report to the Nation on Occupational Fraud & Abuse* (2008).

^{34/} Under the new proposed standards, the auditor has a responsibility to perform risk assessment procedures that provide an appropriate basis for his or her risk assessments. The new proposed standard does not include the provision in the interim standards that allowed the auditor to assess risk at the maximum solely for efficiency reasons. Rather the auditor needs a sufficient understanding of the company and its environment, including its internal control, in order to determine the risks of material misstatement and, in turn, to design effective tests of controls and substantive procedures.

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into account the planned degree of reliance on controls that the auditor plans to test, if the auditor performs tests of controls in accordance with PCAOB standards.

- e. Identifying significant accounts and disclosures and their relevant assertions.
- f. Determining whether any of the identified and assessed risks of material misstatement are significant risks.

Commenters on the provisions of the original proposed standard related to the identification and assessment process suggested that the order of the steps should be changed so that identification of significant accounts and disclosures should occur before the assessment of the identified risks. Under PCAOB standards, significant accounts and disclosures and their relevant assertions are identified based upon their risk characteristics rather than their size. Thus, the auditor needs to identify and assess the risks in order to identify the relevant assertions of significant accounts and disclosures in accordance with PCAOB standards.

Auditing Standard No. 5 requires the auditor to identify significant accounts and disclosures and their relevant assertions in integrated audits. Also, the existing interim standards, as amended by the PCAOB, require the auditor to perform substantive procedures for the relevant assertions of significant accounts and disclosures for all audits of financial statements, which would require the auditor to identify those accounts, disclosures, and assertions.^{35/} The new proposed standard imposes a more explicit requirement to identify significant accounts and disclosures and their relevant assertions in all audits. Based on comments received on the original proposed standard, the Board believes that the new proposed standard should include the provisions from Auditing Standard No. 5 regarding the process for identifying significant accounts and disclosures and their relevant assertions because those provisions also apply to audits of financial statements. Accordingly, the new proposed standard incorporates those provisions.

Some of those commenters also suggested that the original proposed standard would be enhanced by incorporating provisions from Auditing Standard No. 5 regarding

^{35/} A note to AU sec. 319.02 in the existing standards refers auditors to Auditing Standard No. 5 for direction on identifying relevant assertions.

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understanding likely sources of misstatement and performing walkthroughs. The new proposed standard also includes provisions from Auditing Standard No. 5 on those topics because those provisions also apply to audits of financial statements.

The original proposed standard imposed a responsibility to determine whether any of the identified risks of material misstatement is a significant risk. Existing PCAOB standards already impose requirements for responding to significant risks.^{36/} The original proposed standard defined the term "significant risks" and included provisions for identifying those risks. That definition was included in Auditing Standard No. 7, *Engagement Quality Review*.

Some commenters suggested that the definition of "significant risk" in the original proposed standard should be revised to indicate that significant risks are "identified risks" and that they are determined using the "auditor's judgment." The new proposed standard retains the definition from the original proposed standard, with slight revision. Adding the reference to the auditor's judgment is unnecessary and could be confusing because the standard does not explicitly mention professional judgment in other definitions that would necessarily involve judgment. Similarly, the reference to "identified risks" is unnecessary because it is already mentioned in the requirement for determining significant risks.

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

^{36/} See, e.g., paragraph .09 of AU 329 *Analytical Procedures*.

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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?

Proposed Auditing Standard – The Auditor's Responses to the Risks of Material Misstatement

1. Background

This proposed standard establishes requirements for responding to the risks of material misstatement, including responses regarding the general conduct of the audit and responses involving audit procedures. The new proposed standard applies to integrated audits and audits of financial statements only.

2. Linking Assessed Risks and Auditor's Responses

The original proposed standard required the auditor to design and implement appropriate responses to the risks of material misstatement. Some commenters suggested that the original proposed standard should use the term "assessed risks of material misstatements" to improve the linkage between the auditor's responses and the risks assessed in accordance with the original proposed standard on identifying and assessing risks of material misstatement.

In the Board's view, obtaining sufficient appropriate evidence to support the auditor's opinion requires the auditor to adequately respond to the risks of material misstatement. Accordingly, the title and objective of the standard continues to refer to responding to the risks of material misstatement. However, the Board also recognizes that the appropriate identification and assessment of the risks of material misstatement in accordance with the proposed standard on identifying and assessing risks of material misstatement enables the auditor to effectively respond to the risks. Accordingly, the new proposed standard imposes on auditors an unconditional responsibility to design and implement responses that address the risks of material misstatement identified and assessed in accordance with the proposed standard on identifying and assessing risks of material misstatement. Also, the requirements in the new proposed standard have been revised to refer to the "assessed risk of material misstatement" when appropriate. As with the original proposed standard, noncompliance with the new proposed standard on identifying and assessing risks that leads to a failure to identify or appropriately assess a risk of material misstatement also could result in a failure to appropriately

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respond to the risk of material misstatement in accordance with the new proposed standard on auditor's responses.^{37/}

3. Overall Responses to Risks

The original proposed standard required the auditor to respond to the risks of material misstatement through overall responses and responses involving the nature, timing, and extent of audit procedures. Overall responses relate to the general conduct of the audit, e.g., appropriate assignments and supervision of engagement team members, incorporating an element of unpredictability into the audit, and making pervasive changes to the audit. Such responses are required by AU sec. 316 in response to fraud risks, but the proposed standard would extend the requirement to apply to risks of material misstatement due to error or fraud. These responses, by their nature, are appropriate for addressing risks of material misstatement due to error or fraud.

Some commenters indicated that the language of the original proposed standard appeared to limit the element of unpredictability to fraud risks only. Existing PCAOB standards^{38/} require auditors to incorporate an element of unpredictability in response to fraud risks, and the provision in the original proposed standard was intended to broaden its application to address other risks of material misstatement in addition to fraud risks. The new proposed standard indicates that the auditor should incorporate an element of unpredictability as part of the response to the risks of material misstatement, including fraud risks. However, this change to the requirement does not diminish the auditor's responsibilities for incorporating an element of unpredictability in responding to fraud risks.

Commenters also asked for more explanation about "making general changes" as an overall response as required by the original proposed standard, and they indicated that requiring "general changes" might not be appropriate in all audits. The new proposed standard requires the auditor to evaluate whether it is necessary to make pervasive changes to the audit to adequately address the risks of material misstatement.

^{37/} Failure to address a risk of material misstatement also might indicate a failure to comply with the new proposed standard on identifying and assessing risks of material misstatement.

^{38/} AU sec. 316.50.

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The new proposed standard also contains examples of such pervasive changes so that auditors can determine when such changes are necessary.

Existing PCAOB standards require the auditor to apply professional skepticism as part of due care^{39/} and state that the auditor's response to fraud risks involves the application of professional skepticism in gathering and evaluating audit evidence.^{40/} The original proposed standard indicated that the auditor's responses to the risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit evidence. Some commenters observed that the discussion of professional skepticism in the original proposed standard appeared to be limited to the auditor's responses rather than the entire audit. The provision in the original proposed standard was intended to emphasize the importance of professional skepticism in responding to risks of material misstatement, similar to existing PCAOB standards, rather than to limit the application to the auditor's responses only. The new proposed standard indicates that the application of professional skepticism is part of applying due professional care, which occurs throughout the audit.

4. Tests of Controls in the Audit of Internal Control

The original proposed standard contained requirements regarding tests of controls for both the audit of financial statements and the audit of internal control. As discussed previously, the Board has removed requirements that apply solely to audits of internal control from the new proposed standards. Accordingly, the requirements regarding tests of controls in an audit of internal control are not included in the new proposed standard.

It is important to note, however, that in an integrated audit, the tests of controls performed in the audit of internal control are part of the auditor's responses to the risks of material misstatement, as indicated in paragraph 9 of the new proposed standard.^{41/}

^{39/} AU sec. 316.13 and AU secs. 230.07-.09.

^{40/} AU sec. 316.46.

^{41/} Paragraph 39 of Auditing Standard No. 5 states, "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."

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To help facilitate the integration of tests of controls in an integrated audit, the new proposed standard continues to use language similar to that of Auditing Standard No. 5 when describing analogous terms and concepts relating to the testing of controls.

5. Tests of Controls and Control Risk Assessment in the Audit of Financial Statements

Requirements on When to Test Controls

Existing PCAOB standards require auditors to obtain evidence about the design and operating effectiveness of controls (a) when the auditor plans to rely on selected controls to reduce his or her substantive procedures and (b) in those limited circumstances in which the auditor cannot obtain sufficient appropriate evidence through substantive procedures alone.^{42/} Thus, except in those limited circumstances, the existing standards provide auditors with flexibility to decide when or whether to test controls.

The new proposed standards do not change the requirements regarding when testing controls is necessary in audits of financial statements only. In those audits, auditors continue to have the same flexibility in deciding when or whether to test controls and reduce their substantive procedures. The new proposed standard includes additional statements that emphasize the flexibility that auditors have in making these decisions.

Some commenters suggested adding examples of situations in which auditors cannot obtain sufficient appropriate audit evidence through substantive procedures alone. The new proposed standard provides additional examples that are adapted from existing PCAOB standards.^{43/}

Period of Reliance

The original proposed standard stated that when the auditor relies on controls to assess the risk of material misstatement at less than the maximum, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire period of reliance.

^{42/} AU sec. 319.66.

^{43/} AU sec. 319.68.

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Some commenters suggested that the Board provide additional explanation regarding how to apply the concept of the period of reliance, especially when the period of reliance is less than the period covered by the company's financial statements. In particular, some commenters suggested that providing a statement that evidence pertaining only to a point in time may be sufficient for the auditor's purpose, e.g., when testing controls over the entity's physical inventory counting at the period end.

The Board's view is that the concept of the period of reliance is not new. It was introduced in Auditing Standard No. 5 and discussed further in the PCAOB staff guidance, *Staff Views: An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements – Guidance for Auditors of Smaller Public Companies*. The new proposed standard provides a definition of "period of reliance" that parallels the language in paragraph B4 of Auditing Standard No. 5. The new proposed auditing standard does not include the example suggested by the commenters. That example could be misunderstood because it relates only to a point in time rather than to a period of time.

Testing Design Effectiveness in Audits of Smaller, Less Complex Companies

The "Testing Design Effectiveness" section of the original proposed standard required the auditor to test the design effectiveness of the controls selected for testing by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect error or fraud that could result in material misstatements in the financial statements.

Some commenters suggested that the discussion in the original proposed standard on testing design effectiveness of controls should include considerations for smaller, less complex companies, similar to the direction in Auditing Standard No. 5. The new proposed standard includes that additional discussion.

Timing of Tests of Controls

In connection with the removal from the original proposed standards of requirements for tests of controls in an audit of internal control, the Board reassessed the provisions regarding the timing of tests of controls in an audit of financial statements, including the provisions regarding interim testing of controls and use of evidence from past audits.

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In the discussion of interim testing of controls, the provisions in the new proposed standard regarding the evidence necessary to update the results of interim testing has been revised and expanded to highlight matters that are more specific to tests of controls in the audit of financial statements, e.g., the planned degree of reliance on the control.

In the discussion of the use of evidence from past years in the current audit, the new proposed standard retains the principle that the auditor should obtain evidence during the current year audit about the design and operating effectiveness of controls upon which the auditor relies. One commenter expressed a concern that eliminating the auditor's ability to use rotational testing of controls in audits of issuers differs from the ISAs and would be a significant, unnecessary change from current practice. The Board continues to believe that auditors should support their control risk assessments each year with current evidence. When the auditor has tested controls in past audits, the new proposed standard, allows the auditor significant flexibility to adjust the amount of evidence needed based on the relevant factors.

The original proposed standard discussed factors that affect the evidence necessary to support the current year's control risk assessments. Some commenters suggested that the original proposed standard should include all of the factors listed in paragraphs 47 and 58 of Auditing Standard No. 5. The new proposed standard includes additional factors that are relevant to the evaluation of the evidence about the effectiveness of controls needed in the current year in addition to evidence from past audits. These additional factors generally relate to the degree of reliance on the control, the risk that the control will fail to operate as designed, and the nature and amount of evidence that the auditor has already obtained regarding the effectiveness of the controls.

Control Risk Assessment

The original proposed standards described the auditor's responsibilities for assessing control risk. One commenter suggested replacing references to control risk assessment with references to assessment of the risk of material misstatement. Another commenter questioned whether to combine the provisions regarding control risk assessment with the discussion of assessing the risks of material misstatement in the original proposed standard on identifying and assessing risks of material misstatement.

The new proposed standard continues to present a separate discussion of control risk assessment in the response standard. AU sec. 319 establishes

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requirements for assessing control risk. Also, Auditing Standard No. 5 refers to control risk assessments in its discussion of tests of controls in the financial statement audit portion of the integrated audit. The requirements regarding assessing control risks continues to be placed in the new proposed standard after the discussion of tests of controls to emphasize that reliance on controls (i.e., assessment of control risk below the maximum level) must be supported by the results of tests of controls. While evaluating the comments on the discussion of control risk assessment, the Board determined that the proposed standard would be enhanced by expanding the discussion of control risk assessment to describe more specifically situations in which the auditor should assess control risk at the maximum level.

6. Risk of Material Misstatement and Evidence from Substantive Procedures

Existing PCAOB standards indicate that some risks of material misstatement might require responses that require more evidence from substantive procedures because of certain inherent limitations of internal control.^{44/} For example, more evidence from substantive procedures ordinarily is needed for relevant assertions that have a higher susceptibility to management override or to lapses in judgment or breakdowns resulting from human failures. Recent observations from the Board's oversight activities have underscored the importance of this principle. The new proposed standard includes this principle because it is particularly relevant to the determination of the nature, timing, and extent of substantive procedures.

Like the original proposed standard, the new proposed standard contains new provisions regarding the performance of substantive procedures. The new proposed standard states the principle that substantive procedures generally provide persuasive evidence when they are designed and performed to obtain evidence that is relevant and reliable. The new proposed standard also recognizes that some type of substantive procedures, by their nature, produce more persuasive evidence than others and emphasizes that inquiry alone does not provide sufficient appropriate evidence to support a conclusion about a relevant assertion.

^{44/} See, e.g., paragraph .14 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures*.

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7. Substantive Procedures Responsive to Significant Risks

The original proposed response standard stated that for significant risks, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the risks. Existing PCAOB standards indicate that tests of details should be performed in response to significant risks.^{45/}

Some commenters expressed concerns about imposing a presumptively mandatory responsibility for auditors to perform test of details in response to significant risks.

The new proposed standard retains the provision as originally proposed. The nature and importance of significant risks warrant a high level of assurance from substantive procedures to adequately address the risk. Also, analytical procedures alone are not well suited to detecting certain types of misstatements related to significant risks, including, in particular, fraud risks. For example, when fraud risks are present, management might be able to override controls to allow adjustments that result in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions.

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

Proposed Auditing Standard – Evaluating Audit Results

1. Background

This proposed standard describes the auditor's responsibilities regarding the process of evaluating the results of the audit and determining whether sufficient

^{45/} AU sec. 329.09

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appropriate audit evidence has been obtained in order to form the opinion to be presented in the auditor's report. This new proposed standard consolidates into one auditing standard the requirements that are currently included in four separate auditing standards^{46/} to highlight matters that are important to the auditor's conclusions about the financial statements and the effectiveness of internal control.

Commenters generally supported the approach to consolidate the requirements related to evaluating audit results into a single standard.

2. Objective of the Auditor

The objective of the auditor in the original proposed standard was to evaluate the results of the audit in order to form the opinion to be expressed in the auditor's report. Some commenters indicated that the objective of the original proposed standard was too broad and that the original proposed standard should present a series of objectives based upon the individual topics covered in the standard. Another commenter suggested revising the objective in the original proposed standard to include a determination of whether sufficient appropriate audit evidence has been obtained.

Providing a series of objectives would detract from the focus on those matters that are important to the opinion expressed in the auditor's report. Instead, the new proposed standard presents a single objective regarding determining whether the evidence obtained is sufficient and appropriate to support the audit opinion. This revised objective maintains the Board's intended focus on the sufficiency and appropriateness of audit evidence while evaluating audit results.

3. Definition of Misstatement

The original proposed standard defined the term "misstatement" as follows:

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

^{46/} AU sec. 312, regarding evaluating audit results, including uncorrected misstatements; AU sec. 316, regarding fraud considerations that are relevant to the evaluating audit results; AU sec. 329, regarding performing the overall review; and AU sec. 326, *Evidential Matter*, regarding determining whether sufficient appropriate audit evidence has been obtained.

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framework.^{47/} 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 accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Some commenters indicated that the definition applied to "material misstatement" rather than "misstatement," and they suggested revisions to the definition.

The new proposed standard carries forward the definition of "misstatement" substantially as originally proposed. The paragraph is not a definition of "material misstatement." Rather, it emphasizes that misstatements prevent financial statements from being fairly presented in conformity with the applicable financial reporting framework, they can relate to any difference between the reported amounts in the financial statements and those that should be reported, and they can be classified into the broad categories of error and fraud. The definition in the original proposed standard is similar to the definition in an existing auditing interpretation of AU sec. 312, which states, "In the absence of materiality considerations, a misstatement causes the financial statements not to be in conformity with generally accepted accounting principles."^{48/}

Some commenters expressed concern that the definition of "error" was different from the accounting standards. In light of those comments, the definition of "error" has been removed from the new proposed standard, and the definition of "misstatement" has been changed to indicate that an "error" refers to an unintentional misstatement.

4. Performing Analytical Procedures in the Overall Review

The original proposed standard has adapted the requirements in AU secs. 316 and 329 to read the financial statements and disclosures and perform analytical procedures in the overall review. These provisions impose on auditors a responsibility to

^{47/} The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

^{48/} Paragraph .02 of AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312*.

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read the financial statements and perform analytical procedures to (a) assess the auditor's conclusions 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. In particular, the original proposed standard required the auditor to evaluate whether (a) evidence gathered in response to unusual or unexpected transactions, events or amounts previously identified during the audit is sufficient and (b) unusual or unexpected amounts or relationships indicate risks of material misstatement that were not previously identified.

The original proposed standard stated that the nature, timing, and extent of the analytical procedures that should be performed in the overall review depend on the nature of the company and its industry. Some commenters indicated that this statement is not consistent with the purpose of the overall review and that analytical procedures performed in the overall review generally are similar to analytical procedures performed as risk assessment procedures. The new proposed standard indicates that analytical procedures performed in the overall review may be similar to analytical procedures performed as risk assessment procedures.

The original proposed standard also required the auditor to evaluate whether management's responses to the auditor's inquiries about significant unusual or unexpected trends or relationships have been vague, implausible, or inconsistent with other audit evidence and perform procedures as necessary to address the matter. Some commenters indicated that any unusual or unexpected results should be corroborated even if management's response is not vague, implausible, or inconsistent with other audit evidence. The new proposed standard indicates that the auditor should obtain corroboration for management's explanations and should perform additional procedures as necessary if management's responses to audit inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail or precision to be useful.

5. Clearly Trivial

The original proposed standard required the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial. Some commenters suggested adding more explanation of the term "clearly trivial." The new proposed standard has been expanded to emphasize that, if auditors set a threshold for accumulating identified misstatements, that threshold must be set at a de minimis level that could not result in material misstatement of the financial statements, individually or

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in combination with other misstatements, after considering the possibility of further undetected misstatement.

6. Accumulating Misstatements

The original proposed standard required the auditor to accumulate misstatements based on auditor's best estimate of the total misstatements identified in the accounts and disclosures that he or she has tested (which are referred to as "likely misstatement" in existing PCAOB standards^{49/}), not just the amount of misstatements specifically identified (which are referred to as "known misstatement" in existing PCAOB standards). The original proposed standard also indicated that the auditor may distinguish the misstatements among specifically identified misstatements, projected misstatements from substantive audit sampling, and misstatements related to accounting estimates.

Some commenters questioned the provision regarding using the three categories of misstatements and suggested either classifying the misstatements into the categories used in existing PCAOB standards or categorizing them in other ways. The statement in the original proposed standard regarding the three categories was intended to be helpful since the manner in which an auditor follows up on a particular misstatement may depend on the nature of the misstatement and how it was identified. However, since the auditor is required to evaluate each misstatement individually and in combination based on both quantitative and qualitative factors, the additional provision regarding categorizing the misstatements is unnecessary and is not included in the new proposed standard.

Another commenter suggested that the original proposed standard should explain the term "best estimate" and discuss how the auditor would calculate his or her best estimate. As discussed previously, the principle of accumulating the auditor's best estimate of a misstatement is not new, and requirements for determining misstatements related to such estimates already exists in PCAOB standards. For example, when errors are identified in items tested in a substantive procedure using audit sampling, existing PCAOB standards require the auditor to project the misstatements to the entire

^{49/} AU sec. 312.34.

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population and record the projected misstatement rather than the errors in the individual items tested on the summary of accumulated misstatements.^{50/}

Some commenters also expressed concerns that "identified misstatement" was a new term and suggested that the original proposed standard should use an alternative term such as "accumulated misstatement" or "known and likely misstatement." The new proposed standard uses "identified misstatement" to refer to misstatements that are identified during the audit, and those identified misstatements that are more than clearly trivial are required to be accumulated. Because the new proposed standard requires the auditor to use his or her best estimate of the misstatement (which is how existing standards describe "likely misstatements"), it is not necessary to use the term "known and likely misstatements."

7. Considerations When Accumulated Misstatements Approach Materiality

The original proposed standard required the auditor to determine whether the overall strategy needs to be revised when the aggregate of misstatements accumulated during the audit approaches the materiality level used in planning and performing an audit. When the aggregate of misstatements approaches materiality, there likely will be greater than an appropriately low level of risk that possible undetected misstatements, combined with misstatements accumulated during the audit, could be material to the financial statements. If the auditor assesses this risk to be unacceptably high, he or she should perform additional audit procedures or determine that management has adjusted the financial statements so that the risk that financial statements are materially misstated has been reduced to an appropriately low level.

Some commenters suggested that the requirement in the original proposed standard be revised to specify that the effect on an appropriately low level of risk should be based on undetected misstatement and uncorrected misstatements instead of all the accumulated misstatements. Some commenters also suggested replacing "likely will be" with "may be" a greater than an appropriately low level of risk.

After considering these comments, the new proposed standard was revised to state that there likely will be greater than an appropriately low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements

^{50/} See, e.g., AU sec. 312.35 and paragraphs.26-.30 of AU sec. 350, *Audit Sampling*.

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accumulated during the audit that remain uncorrected, could be material to the financial statements. The new proposed standard retains the phrase "likely will be" rather than "may be" because if the aggregate of accumulated misstatements is close to the established materiality level, the risk that the financial statements are materially misstated is likely to be unacceptably high, requiring the auditor to follow the additional steps set forth in the standard.

8. Requirement to Reassess Materiality

As discussed previously, Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*, includes a requirement to reassess materiality under certain circumstances. Some commenters indicated that the original proposed standard should specifically require the auditor to perform that reassessment of materiality before evaluating the effect of uncorrected misstatements so that the evaluation of audit results is based on the latest financial statement information. The new proposed standard states that if the reassessment of materiality as set forth in the new proposed auditing standard on 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.

The original proposed standard stated that if the financial statements contain material misstatements, the auditor should issue a qualified or an adverse opinion. A commenter suggested that this requirement is not needed because it is already included in AU sec. 508, *Reports on Audited Financial Statements*. The new proposed standard replaces this requirement with a reference to AU sec. 508.

9. Evaluating Uncorrected Misstatements

The original proposed standard stated that the auditor should evaluate the uncorrected misstatements in relation to accounts and disclosures and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors. Some commenters indicated that the standard should provide additional discussion of qualitative factors. Based on these comments and observations from the Board's oversight activities, the Board believes that the new proposed standard should retain the existing provisions regarding qualitative factors in the existing auditing interpretation

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with some minor revisions to align the factors more closely to the terminology in the new proposed standard and to omit qualitative factors that apply only to nonissuers.^{51/}

The new proposed standard also mentions examples of situations in which misstatements of relatively small amounts might be considered material for qualitative reasons.

The original proposed standard required the auditor to evaluate the effects of uncorrected misstatements detected in the prior year on the accounts and disclosures and the financial statements as a whole. Some commenters suggested that the original proposed standard should include consideration of misstatements related to the prior year that are detected in the current year. The new proposed standard requires an evaluation of the effects of both uncorrected misstatements detected in prior years and misstatements detected in the current year that relate to prior years.

Like existing PCAOB standards, the new proposed standard does not address how to evaluate the effect of prior period misstatements because that is an accounting and financial reporting matter. For example, the Securities and Exchange Commission ("SEC") staff has provided guidance in SEC Staff Accounting Bulletin ("SAB") No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, on the effects of prior year misstatements when quantifying misstatements in the current year financial statements. This SAB provides the SEC staff's views regarding evaluating the quantitative and qualitative factors regarding the materiality of uncorrected misstatements and evaluating the effects of prior year misstatements.

The new proposed standard states that the auditor cannot assume that an instance of error or fraud is an isolated occurrence and that the auditor should evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement. This procedure is important to inform the auditor's conclusions about whether the auditor's risk assessments remain appropriate and thus whether he or she has obtained sufficient appropriate evidence to support his or her opinion.

Similarly, the new proposed standard requires the auditor to evaluate whether identified misstatements might be indicative of fraud and, in turn, how they affect the

^{51/} AU sec. 9312.15 -.17.

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auditor's evaluation of materiality and the related audit responses. This requirement is adapted from existing PCAOB standards.^{52/} Like existing PCAOB standards, this requirement is phrased in terms of identified misstatements rather than accumulated misstatements because fraud of relatively small amounts can be material to the financial statements. If an auditor detects a misstatement, he or she should evaluate whether the misstatement is indicative of fraud when deciding whether a misstatement is clearly trivial and thus does not warrant including with accumulated misstatements.

10. Communication of Accumulated Misstatements to Management

The original proposed standard required the auditor to communicate accumulated misstatements to management in a timely basis to provide management an opportunity to correct them. Some commenters suggested that the original proposed standard should specifically require the auditor to request management to correct the misstatements. That requirement was retained in the new proposed standard as originally proposed because it accomplishes the objective of the requirement, which is to communicate accumulated misstatements to management. Also, the requirement suggested by the commenters is unnecessary because management has its own legal responsibilities in relation to the preparation and maintenance of the company's books, records, and financial statements.

11. Evaluating the Qualitative Aspects of the Company's Accounting Practices

The original proposed standard required the auditor to assess the qualitative aspects of the company's accounting practices, including possible bias in management's judgments regarding the amounts and disclosures in the financial statements. The purpose of this provision is to direct the auditor to evaluate potential bias in the financial statements, and if such bias exists, whether the effect of management bias in combination with the accumulated uncorrected misstatements causes the financial statements to be materially misstated, and thus not presented fairly in accordance with the applicable financial reporting framework.

Commenters generally supported the inclusion of the provisions regarding evaluation of management bias in the original proposed standard. Some commenters suggested adding a discussion of indicators of management bias and their effect on the auditor's conclusions regarding whether risk assessments and the related audit

^{52/} AU sec. 316.75.

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responses remain appropriate and whether the financial statements are free of material misstatement.

After considering these comments, the new proposed standard states that if the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, he or she 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 new proposed standard states that 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.

The new proposed standard does not cite indicators of bias because the proposed risk assessment standards already provide examples of different forms of management bias. However, the expanded discussion of bias in accounting estimates in the new proposed standard points out that bias can also result from the cumulative effect of changes in multiple accounting estimates.

Based on observations from the Board's oversight activities, the new proposed standard includes another example of management bias – the identification by management of additional adjusting entries that offset other misstatements identified by the auditor. If such misstatements are identified, the new proposed standard would require the auditor to perform procedures to determine why the misstatement was not identified previously, assess the implications on the integrity of management and the auditor's risk assessments, including fraud risk assessments, and perform additional procedures as necessary to address the risk of further undetected misstatements.

12. Misstatements Related to Accounting Estimates

In the original proposed standard, the provision regarding determination of misstatements related to accounting estimates was included in the assessment of bias in accounting estimates. Commenters suggested that the determination of misstatements discussion be moved to the discussion of accumulation of misstatements. They also suggested that the provision on misstatements be expanded to discuss both point estimates and accounting estimates outside of a reasonable range. The new proposed standard has been revised as suggested.

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13. Evaluating Financial Statement Disclosures

The new proposed standard includes the relevant provisions from AU sec. 431, *Adequacy of Disclosure in Financial Statements*, for evaluating financial statement disclosures. These provisions were added to the new proposed standard because of the importance of disclosures to the fair presentation of financial statements.

14. Assessment of Fraud Risks

The original proposed standard required the auditor to evaluate whether the accumulated results of auditing procedures and other observations affect the auditor's assessment of fraud risk made earlier in the audit. This evaluation could provide additional insight regarding the risks of material misstatement due to fraud and the potential need to perform additional procedures to support the opinion to be expressed in the auditor's report. Some commenters suggested replacing the assessment of fraud risk made "earlier in the audit" with "throughout the audit" as fraud risks are considered throughout the audit. Commenters also suggested moving the statement that the auditor's assessment of fraud risks should be ongoing throughout the audit to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*. The new proposed standards have been revised as suggested.

15. Evaluating the Sufficiency and Appropriateness of Audit Evidence

The original proposed standard required the auditor to conclude on whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements. The original proposed standard also presented a list of factors that are relevant to the auditor's conclusions on whether sufficient appropriate audit evidence has been obtained. Commenters observed that the original proposed standard required the auditor to evaluate all of the listed factors, and they suggested that the requirement be changed to allow the auditor to select the factors to be evaluated. The Board believes that the consideration of the listed factors is essential to reaching an informed conclusion about whether sufficient appropriate audit evidence has been obtained, so the new proposed standard retains the requirement as originally proposed.

The requirements regarding situations in which the auditor has not obtained sufficient appropriate audit evidence have been expanded in the new proposed standard to include situations in which the auditor has substantial doubts about a

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relevant assertion. This additional provision is adapted from existing PCAOB standards.^{53/}

16. Evaluating the Results of the Audit of Internal Control

The original proposed standard included a section relating to evaluating audit results in the audit of internal control. In connection with the aforementioned decision to remove from the proposed risk assessment standards provisions relating only to the audit of internal control, the new proposed standard contains only a paragraph that references Auditing Standard No. 5 for the requirements on evaluating the results of the audit of internal control.

Questions

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

Proposed Auditing Standard – Audit Evidence

1. Background

This proposed standard sets forth the auditor's responsibilities regarding designing and performing audit procedures to obtain sufficient appropriate evidence to support the opinion(s) in the auditor's report and discusses methods for selecting items for testing.

2. Nature of Audit Evidence

The original proposed standard stated that audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in

^{53/} AU sec. 326.25.

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arriving at the conclusion on which the audit opinion is based. Audit evidence includes both corroborating and conflicting information. Some commenters suggested that the original proposed standard should indicate that information obtained from previous audits may be used as evidence for the current period audit and that audit evidence includes information contained in the accounting records underlying the financial statements and other information.

The new proposed standard does not include the additional language suggested by the commenters. Such statements are unnecessary because the original proposed standard already stated that evidence encompasses all of the information used by the auditor. Furthermore, including the suggested statements about using information from prior audits or information in the accounting records could result in auditors overlooking the respective requirements in other PCAOB standards for using that information.

3. Objective

The auditor's objective in the original proposed standard was to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report. Some commenters indicated that the objective of the proposed standard was too broad because it related to the entire audit, and they suggested that the objective should be revised to focus on planning and performing audit procedures to obtain sufficient appropriate audit evidence. The revised objective in the new proposed standard acknowledges the auditor's responsibility to plan and perform the audit to obtain sufficient appropriate audit evidence to support the opinion expressed in the auditor's report.

4. Sufficient Appropriate Audit Evidence

The new proposed standard requires the auditor to design and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion, and this requirement applies to both the audit of financial statements and the audit of internal control. The new proposed standard explains the meaning of sufficient and appropriate as used in the phrase "sufficient appropriate audit evidence." The new proposed standard also sets forth principles for evaluating the sufficiency and appropriateness of audit evidence, which auditors should take into account in determining the necessary nature, timing, and extent of their audit procedures.

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The original proposed standard stated that, to be appropriate, audit evidence must be both relevant and reliable. Some commenters indicated that this statement did not acknowledge the degree of relevance and reliability of audit evidence. The new proposed standard clarifies that the audit evidence should be sufficiently relevant and reliable to support the auditor's conclusions about the subject of the audit procedure.

5. Financial Statement Assertions

Financial statement assertions are an important consideration for audits performed in accordance with PCAOB standards. For example, PCAOB standards require auditors to perform substantive procedures for relevant assertions in audits of financial statements and to obtain evidence about the design and operating effectiveness of controls over relevant assertions in audits of internal control.

This original proposed standard retained the five categories of financial statement assertions in AU sec. 326 and Auditing Standard No. 5, and allowed auditors to use categories of assertions that differ from the assertions listed in this standard under specified conditions. Some commenters questioned whether the language in the original proposed standard was intended to imply that the assertions used for the financial statement audit might differ from those for the audit of internal control.

The assertions used by the auditor should be the same for the audit of the financial statements and the audit of internal control. The new proposed standard has been revised to present a single principle that applies to audits of financial statements and to audits of internal control over financial reporting.

6. Selecting Items for Testing

The proposed standard contains a section on selecting items for testing. Currently, this topic is discussed in an auditing interpretation to AU sec. 350, *Audit Sampling*.^{54/} Like the auditing interpretation, the original proposed standard stated that application of an audit procedure to all items in an account or to specific items selected because of their characteristics does not constitute audit sampling, and the results of the procedure cannot be projected to the entire population. Some commenters suggested that the original proposed standard should state that selective examination of the specific items, particularly if those items are selected based on the auditor's belief

^{54/} AU sec. 9350, *Audit Sampling: Auditing Interpretations of AU sec. 350*.

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that they are more likely to contain a misstatement, may provide the auditor with some audit evidence concerning the remainder of the population.

The new proposed standard does not include the suggested statement. In the Board's view, the auditor cannot obtain sufficient appropriate audit evidence to reach a conclusion about one group of items in a population by examining dissimilar items in the population. Adding the suggested statement might result in misunderstandings that, in turn, lead to inadequate testing or incorrect conclusions about the account being tested.

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?

Proposed Amendments to PCAOB Standards

Proposed Amendments to Auditing Standard No. 3

In the release accompanying the original proposed standards, the Board sought comment on the need for specific documentation requirements regarding the risk assessment procedures. Responses from commenters were mixed. Two commenters supported adding specific documentation requirements, four indicated that the existing requirements in Auditing Standard No. 3 are adequate, and one commenter was ambivalent.

After consideration of these comments and additional analysis of the new proposed standards, the Board is proposing certain amendments to Auditing Standard No. 3 to (a) specify certain required documentation regarding the auditor's risk assessments and related responses; (b) align certain terms and provisions of the standard with the new proposed standards;^{55/} and (c) incorporate the principles for

^{55/} See the proposed amendments to paragraphs 9, 12, and 19.

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documentation of disagreements among engagement team members,^{56/} as discussed previously.^{57/}

For example, the proposed amendments indicate that the auditor's documentation should include the following:

- a. A summary of the identified risks of misstatement and the auditor's assessment of risks of material misstatement at the financial statement and assertion levels; and
- b. The auditor's responses to the risks of material misstatement, including a summary of the linkage of the responses to those risks.

Also, the requirements regarding documentation of significant findings or issues and related matters would be expanded by a proposed amendment to include documentation regarding the significant risks identified and the results of the auditing procedures performed in response to those risks.

The proposed new documentation requirements are intended to enhance the auditor's ability to link identified and assessed risks to appropriate responses and could help reviewers understand the areas of greater risk and the auditor's responses to those risks. In addition to these new proposed requirements, the auditor would continue to be responsible for preparing documentation as required by other provisions of Auditing Standard No. 3, e.g., to demonstrate that the engagement complied with the standards of the PCAOB.^{58/}

Proposed Amendments to Auditing Standard No. 4

The proposed amendments to Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, are limited to changing the word "competent" to "appropriate," when that word is used in reference to audit evidence and updating references to auditing standards that are being superseded or amended.

^{56/} See the proposed amendments to paragraph 12.d.

^{57/} See the prior discussion of the proposed standard on audit planning and supervision.

^{58/} Paragraph 5.a. of Auditing Standard No. 3.

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Proposed Amendments to Auditing Standard No. 5

The proposed amendments to Auditing Standard No. 5 are limited to changing the phrase "any assistants" to "the members of the engagement team," changing the word "competent" to "appropriate" when that word is used in reference to audit evidence, and updating references to auditing standards that are being superseded or amended.

As discussed previously, some commenters observed that, on the one hand, the original proposed standards did not include certain essential risk assessment procedures from Auditing Standard No. 5 and, on the other hand, the original proposed standards contained certain requirements regarding testing controls and evaluating audit results in the audit of internal control that overlapped or duplicated requirements in Auditing Standard No. 5. Those commenters suggested incorporating into the risk assessment standards all of the Auditing Standard No. 5 requirements regarding risk assessment procedures and removing from the risk assessment standards all requirements for testing controls and evaluating audit results that applied only to the audit of internal control.

The new proposed standards incorporate the Auditing Standard No. 5 requirements related to identifying and assessing risks of material misstatement and do not include requirements related only to the audit of internal control. The Board does not propose to remove the requirements regarding risk assessment procedures from Auditing Standard No. 5 because those requirements are important to understanding the other provisions of Auditing Standard No. 5.

Proposed Amendments to Auditing Standard No. 6

The proposed amendments to Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, are limited to updating a reference to a standard that is being superseded and removing a footnote stating that the term "error" as used in Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("SFAS No. 154"), is equivalent to "misstatement" as used in the auditing standards. This technical change is proposed because the footnote regarding misstatements in Auditing Standard No. 6 refers to the SFAS No. 154, whereas the definition of "misstatement" in the new proposed standard on evaluating audit results is neutral regarding the financial reporting framework. However, this technical change does not alter the fact that an error under accounting standards generally accepted in the United States is a misstatement under the new proposed standard.

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Proposed Amendments to Auditing Standard No. 7

The proposed amendments to Auditing Standard No. 7 would update footnotes 3 and 10 to replace a reference to an existing interim standard that would be superseded and update the definitions of the terms "engagement partner" and "significant risk," respectively, to conform to the definitions in the new proposed standards.

Proposed Amendments to Interim Auditing Standards

Superseded Sections

The new proposed standards would supersede the following sections of PCAOB interim auditing standards:

- AU sec. 311, *Planning and Supervision*
- AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*
- AU sec. 313, *Substantive Tests Prior to the Balance Sheet Date*
- AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*
- AU sec. 326, *Evidential Matter*
- AU sec. 431, *Adequacy of Disclosure in Financial Statements*

Similarly, the auditing interpretations of AU secs. 311, 312, and 350 have been incorporated into the new proposed standards and thus would be superseded. The auditing interpretations to AU sec. 326, except for Interpretation No. 2 (AU sec. 9326.06-.23), also would be superseded.^{59/}

The original proposed standards and amendments to PCAOB standards did not include superseding AU sec. 431. The essential provisions of AU sec. 431 regarding evaluating disclosures have been incorporated into the new proposed standard on

^{59/} Interpretation No. 2 relates in part to AU sec. 336, and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, and it will be evaluated in connection with standards-setting projects related to those standards.

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evaluating audit results, so AU sec. 431 would be superseded by the new proposed standard.

AU sec. 316, Consideration of Fraud in a Financial Statement Audit

As discussed previously, the relevant requirements and direction regarding identifying and assessing fraud risks, responding to fraud risks and evaluating audit results have been incorporated into the new proposed standards. The remaining portions of AU sec. 316 describe important principles regarding the auditor's responsibility with respect to fraud and more detailed requirements and direction regarding the auditor's responses to fraud risks.

The relevant requirements and direction regarding identifying and assessing fraud risks, principally AU sec. 316.14-.45; responding to fraud risks, principally AU sec. 316.46-.50; and evaluating audit results, principally, AU secs. 316.68-.78; have been incorporated into the new proposed standards. The remaining portions of AU sec. 316 describe important principles regarding the auditor's responsibility with respect to fraud and more detailed requirements and direction regarding the auditor's responses to fraud risks. The amendments to AU sec. 316 include an overview of the auditor's consideration of fraud and, where applicable, references to the appropriate requirements and direction in the new proposed standards.

AU sec. 329, Analytical Procedures

As with the original proposal, the discussion in AU sec. 329 regarding analytical procedures performed during audit planning, principally paragraphs AU secs. 329.03, and 329.06-.08, are incorporated into Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*. Similarly, the requirements and direction regarding analytical procedures in the overall review, principally AU secs. 329.23-.24, are incorporated into Proposed Auditing Standard, *Evaluating Audit Results*. The remaining portion of this standard relates to analytical procedures performed as substantive procedures. Therefore, this standard would be re-titled as *Substantive Analytical Procedures*, which more accurately reflects the content of the amended standard.

A standard that focuses solely on substantive analytical procedures would highlight more clearly the requirements that apply to analytical procedures performed for that purpose. The Board has observed instances in which auditors performed

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substantive procedures to test accounts without meeting the requirements in AU sec. 329 for substantive analytical procedures.^{60/}

AU sec. 350, Audit Sampling

The discussion in AU sec. 350 regarding audit risk and tolerable misstatement has been amended to align more closely with the new proposed standards.

Some commenters on the original proposal expressed concerns about description of the relationship between concept of tolerable misstatement as described in AU sec. 350 and in the new proposed standard on consideration of materiality in planning and performing an audit. The proposed amendments contain a new paragraph that explains that relationship in more detail.

The original proposal included amendments to AU secs. 350.23 and 350.38, which would explain more specifically how the principles in the standard for determining sample sizes when nonstatistical sampling approaches are used. Some commenters expressed concerns that the proposed amendments would have required auditors who use nonstatistical sampling methods to compute sample sizes under both statistical and nonstatistical methods to demonstrate that the sample size under the nonstatistical method equaled or exceeded sample size under a statistical method. The proposed amendments are not intended to require auditors to compute sample sizes using statistical methods in all instances to demonstrate compliance with the requirements. For example, the use of a nonstatistical sampling method that is adapted appropriately from a statistical sampling method also could demonstrate compliance. Accordingly, these amendments are retained as originally proposed.

Other Amendments to the Interim Auditing Standards

For the following interim auditing standards, the proposed amendments are limited to conforming terminology to the new proposed standards and updating references to auditing standards that are being superseded or amended:

- AU sec. 110, *Responsibilities and Functions of the Independent Auditor*
- AU sec. 150, *Generally Accepted Auditing Standards*

^{60/} See, e.g., PCAOB Release 2007-010, *Report on the PCAOB's 2004, 2005 and 2006 Inspections of Domestic Triennially Inspected Firms* (October 22, 2007).

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- AU sec. 230, *Due Professional Care in the Performance of Work*
- AU sec. 310, *Appointment of the Independent Auditor*
- AU sec. 315, *Communications between Predecessor and Successor Auditors*
- AU sec. 317, *Illegal Acts by Clients*
- AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.*
- AU sec. 324, *Service Organizations*
- AU sec. 328, *Auditing Fair Value Measurements and Disclosures*
- AU sec. 330, *The Confirmation Process*
- AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*
- AU sec. 333, *Management Representations*
- AU sec. 334, *Related Parties*, and AU sec. 9334, *Related Parties: Auditing Interpretations of Section 334*
- AU sec. 336, *Using the Work of a Specialist*, and AU sec. 9336, *Using the Work of a Specialist: Auditing Interpretation of Section 336*
- AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
- AU sec. 342, *Auditing Accounting Estimates*, and AU sec. 9342, *Auditing Accounting Estimates: Auditing Interpretation of Section 342*
- AU sec. 411, *The Meaning of Presented Fairly in Conformity With Generally Accepted Accounting Principles*

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- AU sec. 508, *Reports on Audited Financial Statements*, and AU sec. 9508, *Reports on Audited Financial Statements: Auditing Interpretations of Section 508*
- AU sec. 530, *Dating of the Independent Auditor's Report*
- AU sec. 623, *Special Reports*
- AU sec. 722, *Interim Financial Information*

The Board also is proposing certain amendments to paragraph .12 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, to align that standard with related proposed amendments to Auditing Standard No. 3, which were discussed previously. Also, footnote 4 to paragraph .16 of AU sec. 9543, *Part of Audit Performed by Other Independent Auditors: Auditing Interpretation of Section 543*, was deleted because it refers to an interim standard that is being superseded.

Proposed Amendments to Interim Ethics Standards

In the interim ethics standard, ET sec. 102, *Integrity and Objectivity*, the proposed amendments are limited to updating references to auditing standards that are being superseded or amended.

Question

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

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APPENDIX 10

Comparison of the Objectives and Requirements of Proposed Auditing Standards to the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

This appendix discusses certain differences between the objectives and requirements of the accompanying proposed standards in this release and the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and analogous proposed or adopted standards of the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA").^{1/} This analysis does not cover the application and explanatory material in the IAASB standards or proposed ASB standards.^{2/}

This appendix is provided for informational purposes only. It is not a substitute for the proposed standards themselves, which are presented in Appendices 1-7 of this release and discussed further in Appendix 9.

This analysis may not represent the views of the IAASB or ASB regarding the interpretation of their standards.

^{1/} In October 2009, the ASB approved as final standards its redrafted risk assessment standards as part of its clarity project. However, the ASB has not yet published those final standards.

^{2/} Paragraph A59 of International Standard on Auditing ("ISA") 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, indicates that the Application and Other Explanatory Material section of the ISAs "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA." Paragraph A63 of the SAS, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, states that although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU section."

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Proposed Auditing Standard – Audit Risk

As discussed in Appendix 9, the proposed standard describes the components of audit risk.

Analogous discussions of the components of audit risk are included in the IAASB's International Standard on Auditing ("ISA") 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* and the ASB's Statement on Auditing Standards ("SAS"), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, respectively.

1. Basis for auditor's opinion

PCAOB

The proposed standard contains a requirement to form an appropriate basis for expressing an opinion on the financial statements the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.^{3/}

The proposed standard clarifies that obtaining sufficient appropriate audit evidence is part of applying professional due care. See further discussion in Appendix 9.

IAASB and ASB

The ISA contains the following requirement, and the SAS has a similar requirement –

To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

^{3/} AU sec. 110, *Responsibilities and Functions of the Independent Auditor*, and AU sec. 230, *Due Professional Care in the Performance of Work*, provide further discussion of reasonable assurance.

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2. Detection risk and substantive tests

PCAOB

The proposed standard contains a requirement that states, as the acceptable level of detection risk decreases, the assurance provided from substantive tests should increase.^{4/}

While detection risk is reduced by performing audit procedures other than substantive procedures, the proposed standard carries forward a responsibility for the auditor to perform substantive procedures for significant accounts and disclosures that are sufficient to provide reasonable assurance of detecting misstatements that would result in material misstatements of the financial statements. See further discussion in Appendix 9.

IAASB and ASB

The ISA and proposed SAS do not include a similar requirement.

Proposed Auditing Standard – Audit Planning and Supervision

In this section, the analogous IAASB and ASB standards are, unless indicated otherwise, ISA 300, *Planning an Audit of Financial Statements*, and proposed SAS, *Planning an Audit (Redrafted)*, respectively.

1. Planning the audit

PCAOB

The proposed standard contains a requirement to properly plan the audit. This requirement is consistent with the first standard of fieldwork in AU sec. 150, *Generally Accepted Auditing Standards*.

^{4/} Paragraphs .81 and .82 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, contain a similar requirement.

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IAASB and ASB

The ISA and proposed SAS do not include a similar requirement, although it is referenced in the objective of the standards.

2. Audit strategy and planning activities

PCAOB

The proposed standard contains requirements for the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan. When developing the audit strategy and audit plan, the proposed standard requires the auditor to evaluate whether certain matters specified in the standard are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures particularly the audit plan and audit strategy. As discussed in Appendix 9, these matters are adapted from existing PCAOB standards and are important for both the audit of financial statements and an audit of internal control over financial reporting.

IAASB and ASB

The ISA and the proposed SAS also require the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan. However, these standards require the auditor to identify characteristics of the engagement that define its scope, and they do not provide specific matters that the auditor needs to evaluate as part of that process.

3. Multi-location engagements

PCAOB

The proposed standard states that the auditor should determine the extent to which auditing procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The auditor should assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit. The proposed standard

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also provides a list of factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures.

The proposed standard adapted the requirements from existing PCAOB standards while refining the provisions regarding consideration of risk for individual locations.^{5/} See further discussion in Appendix 9.

The provisions in the proposed standard are applicable to all multi-location audits, not just group audits.

IAASB and ASB

ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* and the proposed SAS, *Audits of Group Financial Statements (Including the Work of Component Auditors)*, apply to audits of financial statements that include financial information from more than one component. These standards also describe the scope of audit procedures to be performed at individual components, depending upon, among other things, whether the components are significant components as described in the standards.

4. Supervision

PCAOB

The proposed standard specifies that the engagement partner is responsible for supervising other engagement team members, but may seek assistance from appropriate engagement team members. The proposed standard also requires the auditor to properly supervise the members of the engagement team, discusses the elements of proper supervision, and includes factors that affect the level of supervision.

^{5/} See AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*.

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These requirements are adapted from existing PCAOB standards and explicitly describe the engagement partner's responsibility.^{6/}

IAASB and ASB

The ISA and the proposed SAS require the auditor to plan the nature, timing, and extent of direction and supervision of engagement team members and review their work. ISA 220, *Quality Control for an Audit of Financial Statements*, and the proposed SAS, *Quality Control for an Audit of Financial Statements*, require the engagement partner to "take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements and for the auditor's report being appropriate in the circumstances."

Proposed Auditing Standard – Consideration of Materiality in Planning and Performing an Audit

In this section, the analogous IAASB and ASB standards are ISA 320, *Materiality in Planning and Performing an Audit*, and proposed SAS, *Materiality in Planning and Performing an Audit (Redrafted)*, respectively.

1. Definition of Materiality

PCAOB

The proposed standard requires the auditor to establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances, including consideration of the company's earnings and other relevant factors. As discussed in Appendix 9, the requirement in the proposed standard is based on the concept of materiality that is articulated by the Supreme Court of the United States in interpreting the federal securities laws.

IAASB and ASB

The ISA states, "When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole." The proposed SAS has a similar requirement.

^{6/} See AU sec. 311, *Planning and Supervision*, and Auditing Standard No. 5.

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2. Determining Tolerable Misstatement^{7/}

PCAOB

The proposed standard contains a requirement to take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods when determining tolerable misstatement and planning and performing audit procedures. This requirement is adapted from existing PCAOB standards.^{8/}

IAASB and ASB

The ISA and proposed SAS require the auditor to determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures.

3. Multi-Location Materiality Determination

PCAOB

The proposed standard discusses materiality for multi-location engagements in the context of an audit of consolidated financial statements of a company that has multiple locations or business units. The proposed standard requires the auditor to establish the materiality level to be used in performing audit procedures at the business units or locations at an amount that is generally less than the materiality level for the consolidated financial statements as a whole. This requirement is intended to allow for the risk of undetected or uncorrected misstatements in the business units or locations exceeding the materiality level at the consolidated financial statements level. Additionally, the proposed standard establishes a principle for determining how to establish materiality for a particular location or business unit. As discussed earlier in this Appendix, the provisions in the proposed standard are applicable to all multi-location audits, not just group audits.

^{7/} The ISA and proposed SAS use the term "performance materiality." The proposed standard retains the term "tolerable misstatement," which is used in existing PCAOB standards. Appendix 9 discusses the difference in terminology.

^{8/} AU sec. 312.23.

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IAASB

The ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*, requires the group engagement team to determine, among other things, component materiality. The ISA states –

Component materiality for those components where component auditors will perform an audit or a review for purposes of the group audit. To reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole, component materiality shall be lower than materiality for the group financial statements as a whole.

ASB

Proposed SAS, *Audits of Group Financial Statements (Including the Work of Component Auditors)*, requires the group engagement team to determine among other things, component materiality. The proposed SAS states –

Component materiality for those components on which an audit or other specified audit procedures will be performed. To reduce the risk that the aggregate of detected and undetected misstatements in the group financial statements exceeds the materiality for the group financial statements as a whole, component materiality should be lower than the materiality for the group financial statements as a whole.

Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement

In this section, the analogous IAASB standards are ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*, and ISA 240, *The Auditor's Responsibilities Relating to Fraud In An Audit of Financial Statements* (collectively referred to in this section as "the ISAs"). The analogous ASB standards are proposed SAS, *Understanding the Entity and its Environment and Assessing Risk* (Redrafted) and proposed SAS, *Consideration of Fraud In A Financial Statement Audit* (Redrafted) (collectively referred to in this section as "the proposed SASs").

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1. Performing Risk Assessment Procedures

PCAOB

The proposed standard includes a requirement to 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 and to design further audit procedures. In a risk-based audit, the auditor's testing of accounts and disclosures is directed toward the areas of greatest risk. This requirement is intended to establish principles for determining the sufficiency of risk assessment procedures.

IAASB and ASB

The ISAs state –

The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

The proposed SASs have similar requirements.

2. Obtaining an Understanding of the Company and its Environment

PCAOB

The proposed standard includes a requirement to evaluate, while obtaining an understanding of the company, whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement. This requirement is adapted from existing PCAOB standards, which recognize that financial reporting risks can arise due to circumstances such as changes in operating environment; new personnel; new or revamped information systems; rapid growth; new technology; new business models, products, or activities;

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corporate restructurings; expanded foreign operations; and new accounting pronouncements.^{9/}

IAASB and ASB

The ISAs and proposed SASs do not include a similar requirement.

3. Nature of the Company

PCAOB

As part of obtaining an understanding of the nature of the company, the proposed standard would require the auditor to consider performing certain procedures, such as reading public information about the company, observing or reading transcripts of earnings calls, obtaining an understanding of compensation arrangements with senior management, and obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders.

IAASB and ASB

The ISAs and proposed SASs do not include a similar requirement.

4. Obtaining an Understanding of Internal Control Over Financial Reporting

PCAOB

The proposed standard requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements; (b) assess the factors that affect the risks of material misstatement; and (c) design further auditor procedures. Like existing PCAOB standards, the proposed standard sets forth the principle for determining the sufficiency of the understanding of internal control over financial reporting.^{10/}

^{9/} AU sec. 319.38.

^{10/} AU sec. 319.25.

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IAASB and ASB

The ISAs and the proposed SASs require the auditor to obtain an understanding of internal control relevant to the audit.

5. Control Environment

PCAOB

The proposed standard contains a requirement for the auditor to assess the following matters as part of obtaining an understanding of the control environment:

- (a) Whether management's philosophy and operating style promote effective internal control over financial reporting;
- (b) Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- (c) Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

This requirement is aligned with the requirements in Auditing Standard No. 5 for evaluating the control environment. See appendix 9 for additional details.

Because of the importance of the control environment to effective internal control over financial reporting, the proposed standard includes a new requirement that indicates that if the auditor identifies a control deficiency in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor.

IAASB and ASB

The ISAs state –

The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

- (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and

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(b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment.

The proposed SASs include similar requirements.

6. Understanding the Company's Risk Assessment Process

PCAOB

The proposed standard requires the auditor to obtain an understanding of management's process for (a) identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud; (b) assessing the likelihood and significance of misstatements resulting from those risks; and (c) deciding about actions to address those risks. Obtaining an understanding also includes obtaining an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.

The proposed standard does not prescribe specific audit procedures based on the level of formality or documentation of a company's risk assessment component of internal control over financial reporting.

IAASB and ASB

The requirements in the ISAs and the proposed SASs are similar to those in the proposed standard for the auditor to obtain an understanding of the company's risk assessment process as part of obtaining an understanding of internal control. The ISAs and the proposed SASs include additional requirements for situations in which the company has no formal risk assessment process or a lack of documentation regarding the process.

7. Relationship of Understanding of Internal Control Over Financial Reporting to Tests of Controls

PCAOB

The proposed standard includes a requirement that the auditor should take into account the evidence obtained from understanding internal control when assessing

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control risk and, in the audit of internal control over financial reporting, forming conclusions about the effectiveness of controls. The proposed standard also includes a requirement to take into account the evidence obtained from understanding internal control when determining the nature, timing, and extent of procedures necessary to support the auditor's conclusions about the effectiveness of entity-level controls in the audit of internal control over financial reporting. The requirements related to performing the audit of internal control over financial reporting are unique PCAOB standards.

IAASB and ASB

The ISAs and proposed SASs do not include similar requirements.

8. Considering Information from the Client Acceptance and Retention Evaluation, Audit Planning Activities, Past Audits, and Other Engagements

PCAOB

The proposed standard includes a requirement to evaluate whether information obtained during a review of interim financial information in accordance with AU sec. 722, *Interim Financial Information*, is relevant to identifying risks of material misstatement in the year-end audit. This requirement is unique to the PCAOB standards.

The proposed standard also states that if the auditor has obtained other information relevant to identifying risks of material misstatement through other engagements performed for the company, the auditor should take that into account in identifying risks of material misstatement. This provision is adapted from existing PCAOB standards^{11/} and is discussed in detail in Appendix 9.

IAASB and ASB

The ISAs state, "if the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to the identifying risks of material misstatement."

^{11/} Paragraph .03 of AU sec. 9311, *Planning and Supervision: Auditing Interpretation of Section 311*.

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The proposed SASs include a similar requirement.

9. Performing Analytical Procedures

PCAOB

The proposed standard contains a requirement, which is adapted from existing PCAOB standards, to perform analytical procedures regarding revenue as risk assessment procedures with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement, including material misstatement due to fraud.^{12/}

The proposed standard also includes a requirement to take into account analytical procedures performed in accordance with AU sec. 722 when designing and applying analytical procedures as risk assessment procedures. This requirement is unique to PCAOB standards.

IAASB

The ISAs state –

The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

ASB

The proposed SASs state –

Based on analytical procedures performed as part of risk assessment procedures, the auditor should evaluate whether unusual or unexpected relationships that have been identified indicate risks of material misstatements due to fraud. To the extent not already included, the analytical procedures and evaluation thereof should include procedures relating to revenue accounts.

^{12/} Paragraph .29 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

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10. Discussion of the Potential for Material Misstatement Due to Fraud

PCAOB

The proposed standard carries forward a requirement from existing PCAOB standards for discussion among the key engagement team members of certain matters regarding fraud, including how and where the company's financial statements might be susceptible to material misstatement due to fraud, known fraud risk factors, the risk of management override of controls, and possible responses to fraud risks.^{13/} The proposed standard also includes a requirement to emphasize certain matters to all engagement team members, including the need to be alert for information or other conditions that might affect the assessment of fraud risks, and actions to be taken if information or other conditions indicate a material misstatement due to fraud might have occurred. These requirements establish a principle for determining the persons who should participate in the discussion among the engagement team members as well as what should be discussed. The ISAs do not include requirements regarding the specific matters to be discussed among the engagement team members.

IAASB

ISA 315 states –

The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion.

ISA 240 states –

ISA 315 requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to engagement team members not involved in the discussion.^{14/} This discussion shall place particular emphasis on how and

^{13/} AU secs. 316.14-.17.

^{14/} Paragraph 10 of ISA 315.

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where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity.

ASB

The proposed SASs include requirements similar to the proposed PCAOB standard regarding the matters to be discussed among engagement team members.

11. Inquiring of the Audit Committee, Management, and Others within the Company about the Risks of Material Misstatement

PCAOB

The proposed standard requires the auditor to make inquiries of management and the audit committee regarding tips or complaints about the company's financial reporting. In light of research indicating that many incidents of fraud are uncovered through tips,^{15/} this inquiry could provide important evidence about risks of material misstatement due to fraud.

IAASB and ASB

The ISAs and the proposed SASs do not have a similar requirement.

12. Identifying Significant Accounts and Disclosures and Relevant Assertions

PCAOB

The proposed standard specifically requires the auditor to identify significant accounts and disclosures and their relevant assertions in all audits as part of assessing risks. This requirement is adapted from existing PCAOB standards^{16/}, and it is relevant to integrated audits and to audits of financial statements only, as discussed in Appendix 9.

^{15/} See, e.g., Association of Certified Fraud Examiners, *2008 Report to the Nation on Occupational Fraud & Abuse* (2008).

^{16/} AU sec. 319.02 and paragraphs 28-33 of Auditing Standard No. 5.

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IAASB

The ISAs state, "The auditor shall identify and assess the risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures."

ASB

The proposed SASs state, "To provide a basis for designing and performing further audit procedures, the auditor should identify and assess the risks of material misstatement at the relevant assertion level related to each material class of transactions, account balance, and disclosure."

13. Understanding Likely Sources of Misstatement

PCAOB

The proposed standard incorporates the provisions from Auditing Standard No. 5 regarding understanding likely sources of misstatements because these provisions also apply to financial statement audits. See further discussion in Appendix 9.

IAASB and ASB

The ISAs and proposed SASs do not have a similar requirement.

Proposed Auditing Standard – The Auditor's Responses to the Risk of Material Misstatement

In this section, the analogous IAASB standards are ISA 330, *The Auditor's Responses to Assessed Risks*, and ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* (collectively referred to in this section as "the ISAs"). The analogous ASB standards are the proposed SASs, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (Redrafted)*, and the proposed SAS, *Consideration of Fraud in a Financial Statement Audit* (collectively referred to in this section as "the proposed SASs").

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1. Objectives

PCAOB

The objective of the auditor in the proposed standard is "to address the risks of material misstatement through appropriate overall audit responses and audit procedures." The objective in the proposed standard emphasizes that the auditor's responses must be sufficient to address the risks of material misstatements.

IAASB and ASB

The objective of the auditor in ISA 330 and the proposed SASs is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

2. Overall Responses

PCAOB

The proposed standard contains a requirement to design and implement overall responses in certain areas (e.g., making appropriate assignments of specific engagement responsibilities, providing an appropriate level of supervision, incorporating elements of unpredictability in selecting auditing procedures, and evaluating the company's selection and application of significant accounting principles) to address the risks of material misstatement at the financial statement level and the significant account or disclosure level. Such responses are required by AU sec. 316 in response to fraud risks, but the proposed standard would extend the requirement to apply to risks of material misstatement due to error or fraud. These responses, by their nature, are appropriate for addressing risks of material misstatement due to error or fraud.

IAASB and ASB

The ISAs and proposed SASs include requirements to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level and requirements for particular types of responses to the risks of material misstatement due to fraud at the financial statement level.

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3. Application of Professional Skepticism

PCAOB

The proposed standard adapted the existing requirements in AU sec. 316 regarding applying professional skepticism and extended the requirements to all risks of material misstatements due to error or fraud. The proposed standard also discusses how the auditor can apply professional skepticism in response to fraud risks.

The existing requirement in AU sec. 230, *Due Professional Care in the Performance of Work*, requires the auditor to apply due professional care and exercise professional skepticism in planning and performing his or her work, including responding to the risks of material misstatements. Due to the special risks posed by fraud, the Board believes that providing additional direction regarding how to respond to fraud risks can be helpful.

IAASB and ASB

The ISAs and the proposed SASs require the auditor to plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.

4. Evaluating Effectiveness of Controls in the Audit of Financial Statements

PCAOB

In discussing obtaining evidence about the effectiveness of controls in the audit of financial statements, the proposed standard establishes the principle that the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The greater the reliance on a control, the more persuasive evidence the auditor is required to obtain from the tests of controls. In addition, the auditor is required to obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls. This requirement is an extension of the principle in the existing standard.

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IAASB and ASB

The ISAs and the proposed SASs include a similar requirement for the auditor to obtain more persuasive audit evidence the greater the reliance he or she plans to place on the effectiveness of a control.

5. Testing Operating Effectiveness of a Control

PCAOB

In discussing testing of operating effectiveness, the proposed standard requires the auditor to determine whether the control selected for testing is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. The proposed standard also discusses the procedures the auditor performs in testing operating effectiveness. To help facilitate the test of controls in an integrated audit, the proposed standard continues to use language similar to that of Auditing Standard No. 5 when describing analogous terms and concepts relating to the testing of controls.

IAASB and ASB

The ISAs and the proposed SASs do not have a similar requirement to determine whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

6. Tests of Controls in Integrated Audits

PCAOB

The proposed standard contains a requirement to design the tests of controls to meet the objectives of both the audit of the financial statements and the audit of internal control over financial reporting in an integrated audit. This requirement is adapted from existing PCAOB standards.^{17/} Integrated audits are unique to PCAOB standards.

IAASB and ASB

The ISAs and proposed SASs do not include similar requirements.

^{17/} Paragraph 7 of Auditing Standard No. 5.

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7. Rotational Testing of Controls

PCAOB

The proposed standard contains a requirement to obtain evidence in the current year about the design and operating effectiveness of controls selected for testing. Appendix 9 discusses this subject in further detail.

IAASB and ASB

The ISAs and proposed SASs allow rotational testing of controls under certain conditions set forth in the standards, and those standards contain requirements that apply to the use of evidence about controls obtained in prior audits.

8. Assessing Control Risk

PCAOB

The proposed standard contains a requirement to assess control risk for relevant assertions by evaluating the evidence from all sources, including the auditor's testing of controls for the audit of internal control and the audit of the financial statements, misstatements detected during the financial statement audit, and any identified control deficiencies. The proposed standard also would require that control risk be assessed at the maximum level for relevant assertions for which controls necessary to sufficiently address the assessed risk of material misstatement in those assertions are missing or ineffective or when the auditor has not obtained sufficient appropriate audit evidence about the effectiveness of those controls. These requirements are adapted from existing PCAOB standards.^{18/}

IAASB and ASB

The ISAs and proposed SASs contain requirements regarding evaluating the operating effectiveness of controls and identified control deviations, but those standards do not require a separate assessment of control risk.

^{18/} AU sec. 319.86 and paragraphs B4-B5 of Auditing Standard No. 5.

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9. Dual-purpose Tests

PCAOB

The proposed standard states that, when dual-purpose tests are performed, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested. These requirements are adapted from existing PCAOB standards.^{19/}

IAASB and ASB

The ISAs and proposed SASs do not have similar requirements.

10. Substantive Procedures

PCAOB

The proposed standard has a requirement, adapted from existing PCAOB standards, to perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.^{20/} Like existing standards, the proposed standard focuses the auditor's responses on relevant assertions of significant accounts and disclosures.

IAASB and ASB

The ISAs state, "The auditor shall design and perform further audit procedures whose nature, timing, and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level." The proposed SAS includes similar requirement except that it uses the term "relevant assertion."

^{19/} AU sec. 319.108.

^{20/} AU sec. 319.02.

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11. Consideration of Confirmations

PCAOB

As discussed above, the proposed standard requires the auditor to perform substantive procedures for each relevant assertion of each significant account and disclosure. The standard also discusses how to determine the types and combination of substantive audit procedures necessary to detect material misstatements in relevant assertions.

AU sec. 330, *The Confirmation Process*, establishes requirements regarding the use of confirmation procedures.^{21/} The proposed risk assessment standards discuss the auditor's responsibilities for designing and performing the substantive procedures necessary to address the risks of material misstatement.

IAASB and ASB

ISA 330 specifically requires the auditor to consider whether external confirmation procedures are to be performed as substantive audit procedures. The proposed SASs does not contain such a specific requirement.

12. Determining Whether to Perform Interim Substantive Procedures

PCAOB

The proposed standard requires the auditor to take into account a series of factors when determining whether it is appropriate to perform substantive procedures at an interim date. The factors discussed in the proposed standard are adapted from existing requirements in PCAOB standards.^{22/}

IAASB and ASB

The ISAs and the proposed SASs do not contain an equivalent requirement for the auditor to take into account the factors listed in the PCAOB proposed standard

^{21/} The Board has a separate standard setting project on confirmations.

^{22/} Paragraphs .04-.07 of AU sec. 313, *Substantive Tests Prior to the Balance Sheet Date*.

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when determining whether it is appropriate to perform substantive procedures at an interim date.

13. Substantive Procedures Covering the Remaining Period

PCAOB

In describing the auditor's responsibilities regarding performing substantive procedures covering the remaining period when certain substantive procedures have been performed at an interim date, the proposed standard has a requirement to compare relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual. This requirement is adapted from existing PCAOB standards.^{23/}

IAASB and ASB

The ISAs and proposed SASs contain requirements to cover the period between the interim testing date and year end by performing substantive procedures, combined with tests of controls for the intervening period, or by performing further substantive procedures only if the auditor determines that doing so would be sufficient.

14. Response to Significant Risks

PCAOB

The proposed standard adapted a requirement from existing PCAOB standards to perform substantive procedures, including tests of details, that are specifically responsive to significant risks.^{24/}

The Board believes that requiring the auditor to perform tests of details that are specifically responsive to significant risks is appropriate as (1) the nature and importance of significant risks warrant a high level of assurance from substantive procedures to adequately address the risk; and (2) analytical procedures alone are not well suited to detecting certain types of misstatements related to significant risks,

^{23/} AU sec. 313.08.

^{24/} Paragraph .09 of AU sec. 329, *Analytical Procedures*.

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including, in particular, fraud risks. See Appendix 9 for further discussion regarding this topic.

IAASB and ASB

The ISAs state –

If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

The proposed SASs include similar requirements.

Proposed Auditing Standard – Evaluating Audit Results

In this section, the analogous IAASB standards are ISA 450, *Evaluation of Misstatements Identified During the Audit*, ISA 330, *Auditor's Responses to Assessed Risks*, ISA 520, *Analytical Procedures*, ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, ISA 540, *Auditing Accounting Estimates Including Fair Value Accounting Estimates, and Related Disclosures*, and ISA 700, *Forming an Opinion and Reporting on Financial Statements* (collectively referred as "the ISAs"). The analogous ASB standards are proposed SASs, *Evaluation of Misstatements Identified During the Audit*, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatements*, *Consideration of Fraud in a Financial Statement Audit*, *Proposed Statement on Auditing Standards, Analytical Procedures*, and *Forming an Opinion and Reporting on Financial Statements* (collectively referred to as "the proposed SASs").

1. Performing Analytical Procedures in the Overall Review

PCAOB

In the overall review, the proposed standard contains requirements to 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

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material misstatement. These requirements were adapted from existing PCAOB standards.^{25/} The conclusions formed from the results of the overall review of the audit are intended to corroborate the conclusions formed during the audit of the significant accounts and disclosures and the financial statements as a whole.

IAASB and ASB

The ISAs state –

The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

The proposed SASs have similar requirements.

2. Evaluating Evidence from Analytical Procedures

PCAOB

The proposed standard contains a requirement, which was adapted from existing PCAOB standards,^{26/} to evaluate whether the evidence gathered in response to unusual or unexpected transactions, events, amounts or relationships previously identified during the audit is sufficient, and whether unusual or unexpected transactions, events, amounts, or relationships indicate risks of material misstatement that were not identified previously, including, in particular fraud risks as part of the overall review. The proposed standard specifies the matters that the auditor should evaluate during the overall review.

IAASB

The ISAs state –

The auditor shall evaluate whether analytical procedures that are performed near the end of the audit, when forming an overall conclusion as to whether the financial statements as a whole are consistent with the

^{25/} AU sec. 329.23.

^{26/} Ibid.

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auditor's understanding of the entity and its environment, indicate a previously unrecognized risk of material misstatement due to fraud.

ASB

The proposed SASs state –

The auditor should evaluate whether the accumulated results of auditing procedures, including analytical procedures, that are performed during the audit, in the overall review stage, or in both stages, when forming an overall conclusion concerning whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment, indicate a previously unrecognized risk of material misstatement due to fraud.

3. Analytical Procedures Regarding Revenue

PCAOB

The proposed standard includes a requirement, adapted from existing standards for the auditor to perform analytical procedures relating to revenue through the end of the period.^{27/} These procedures are intended to identify unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement due to fraudulent financial reporting.

IAASB

The ISAs state –

The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

^{27/} AU sec. 316.70.

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ASB

The proposed SASs include a similar requirement as the proposed PCAOB standard to perform analytical procedures related to revenue.

4. Corroborating Management Explanations

PCAOB

The proposed standard contains a requirement to corroborate management's explanations regarding significant unusual or unexpected transactions, events, amounts or relationships. The proposed standard also states that if management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures as necessary to address the matter. The proposed standard specifically requires the auditor to corroborate management's explanations regarding significant matters.

IAASB and ASB

The ISAs require the auditor to investigate the identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount by (a) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and (b) performing other audit procedures as necessary in the circumstances. The ISAs also include a requirement to investigate inconsistent responses to inquiries from management and those charged with governance.

The proposed SASs have similar requirements.

5. Accumulating and Evaluating Identified Misstatements

PCAOB

The proposed standard contains a requirement to communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them as further discussed in Appendix 9. This requirement fulfills the auditor's responsibility to communicate the misstatements and a subsequent

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provision of the standard discusses the auditor's responsibility for evaluating the misstatements that are corrected.

IAASB and ASB

The ISAs and proposed SASs contain requirements to communicate on a timely basis all misstatements accumulated during the audit to an appropriate level of management and to request that management correct those misstatements.

6. Evaluating Misstatements – Effect on Risk Assessments

PCAOB

The proposed standard contains a requirement to evaluate the effect of individual misstatements accumulated during the audit on the assessed risks of material misstatements in determining whether the risk assessments remain appropriate. Such an evaluation is important to inform the auditor's conclusions about whether the auditor's risk assessments remain appropriate and whether he or she has obtained sufficient appropriate evidence to support his or her opinion.

IAASB and ASB

The ISAs and proposed SASs do not have a similar requirement to evaluate the effect of individual misstatements accumulated during the audit on the assessed risks of material misstatement.

7. Evaluating Misstatements – Fraud Considerations

PCAOB

The proposed standard has a requirement, adapted from existing PCAOB standards, to evaluate whether identified misstatements might be indicative of fraud and, in turn, how they affect the auditor's evaluation of materiality and the related audit responses.^{28/} Like existing standards, this requirement is phrased in terms of identified misstatements rather than accumulated misstatements because fraud of relatively small amounts can be material to the financial statements. If an auditor detects a misstatement, he or she should evaluate whether the misstatement is indicative of fraud

^{28/} AU sec. 316.75.

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when deciding whether a misstatement is clearly trivial and thus does not warrant including with accumulated misstatements.

IAASB and ASB

The ISAs and proposed SASs contain a requirement to evaluate whether a misstatement is indicative of fraud, and if so, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations. The proposed SASs contain a similar requirement to the ISAs and also require the auditor to evaluate the implications of the misstatement on the auditor's evaluation of materiality, management, and employee integrity.

8. Communication of Illegal Acts

PCAOB

The proposed standard requires the auditor to determine his or her responsibility under AU sec. 316.79-.82A, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j-1, if the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred.

IAASB and ASB

The ISAs state that if the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management. The proposed SASs have a similar requirement.

9. Evaluating the Qualitative Aspects of the Company's Accounting Practices

PCAOB

The proposed standard states that if the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, he or she should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. The proposed standard also contains a requirement to evaluate whether the auditor's risk

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assessments, including assessment of risks of material misstatement due to fraud and the related responses remain appropriate.

The purpose of this provision is to direct the auditor to evaluate potential bias in the financial statements, and if such bias exists, whether the effect of management bias in combination with the accumulated uncorrected misstatements causes the financial statements to be materially misstated, and thus not presented fairly in accordance with the applicable financial reporting framework. See further discussion in Appendix 9.

IAASB and ASB

The ISAs and proposed SASs contain a requirement for the auditor to evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

10. Evaluating Conditions Relating to Assessment of Fraud Risks

PCAOB

The proposed standard contains a requirement, which was adapted from existing PCAOB standards, for the engagement partner to ascertain whether there has been appropriate communication with the other engagement team members regarding information or conditions indicating fraud risks.^{29/} This requirement imposes a specific responsibility for the engagement partner to determine that necessary fraud related matters have been communicated.

IAASB

The ISAs contain a requirement for a discussion among the engagement team members and a determination by the engagement partner of matters to be communicated to those team members not involved in the discussion.

^{29/} AU sec. 316.18.

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ASB

The proposed SASs contain a similar requirement to the PCAOB proposed standard for the engagement partner to ascertain that appropriate communication exists about the need for the discussion of fraud risks among team members throughout the audit.

Proposed Auditing Standard – Audit Evidence

In this section, the analogous IAASB and ASB standards are ISA 500, *Audit Evidence*, and proposed SAS, *Audit Evidence (Redrafted)*, respectively.

1. Objective and Overarching Requirement

PCAOB

The objective of the auditor in the proposed standard is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report. The proposed standard includes a requirement, adapted from existing PCAOB standards, for the auditor to design and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for the auditor's opinion.^{30/} The objective of the proposed standard together with the requirement clearly articulates the linkage between the auditor's responsibility to obtain sufficient appropriate audit evidence and to support his or her opinion.

IAASB and ASB

The objective of the auditor in the ISA states, "The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion." The requirement of the ISA states, "The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence." The proposed SAS has a similar objective and requirement.

^{30/} Paragraph .22 of AU sec. 326, *Evidential Matter*.

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2. Document Authentication

PCAOB

The proposed standard includes a statement, adapted from existing PCAOB standards, that the auditor is not expected to be an expert in document authentication. The proposed standard also states that if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions and should determine the effect, if any, on the other aspects of the audit.^{31/}

IAASB and ASB

The ISA states, "Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further." The proposed SAS includes a similar requirement.

3. Evaluating Information Produced by the Company

PCAOB

The proposed standard includes a requirement, adapted from existing PCAOB standards, to evaluate whether the information produced by the company is sufficient and appropriate for the purposes of the audit, by performing procedures such as –

- Testing the accuracy and completeness of the information, or testing the controls over the accuracy and completeness of that information.
- Evaluating whether the information is sufficiently precise and detailed for purposes of the audit.

^{31/} AU sec. 316.09 and AU sec. 316.68, footnote 26.

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IAASB and ASB

The ISA and the proposed SAS include requirements to evaluate whether the information produced by the entity is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances –

- Obtaining audit evidence about the accuracy and completeness of the information.
- Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes.

4. Selecting Items for Testing to Obtain Audit Evidence

PCAOB

The proposed standard states that the auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure. This establishes an overall principle for selecting items for testing, consistent with an existing auditing interpretation.^{32/}

IAASB and ASB

The ISA indicates that when designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure. The proposed SAS has a similar requirement.

^{32/} AU sec. 9350, *Audit Sampling: Auditing Interpretations of Section 350*.