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auditing standards regarding risk assessment were adopted, for the most part, during the 1980s. As described below, these proposals have been informed by a number of factors and developments since that time. These include improvements that many firms have made in their audit methodologies; recommendations to the profession on ways in which auditors could improve risk assessment; advice from the Board's Standing Advisory Group ("SAG"); 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 proposals build upon and attempt to improve the framework established by the existing standards, rather than replacing that framework altogether. Accordingly, while the Board is proposing to supersede several of its interim standards, the concepts underpinning the proposed standards should be familiar to most auditors.

At the most basic level, the proposed standards are, like the existing standards, rooted in the concept of audit risk. Audit risk can be described as the risk that the auditor will express an inappropriate opinion when the financial statements are materially misstated. The objective of an audit of financial statements is to limit audit risk to a low level, so that the auditor can opine with reasonable assurance that the financial statements present fairly, in all material respects, a company's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles ("GAAP"). Prior to the 1980s, auditing standards said little about how to assess and manage the risks inherent in the audit process. For many years, risk assessment was largely confined to assessing the risks inherent in the accounts and performing a study and evaluation of internal control. Testing of financial statement accounts was often based primarily on the size and nature of the accounts. The formal assessment of risk occurred primarily when auditors applied audit sampling methods.

In the 1980s, generally accepted auditing standards began to apply audit risk concepts to the entire audit, not just to audit sampling.^{1/} The standards adopted during this period explain that audit risk consists of the risk that the financial statements are materially misstated due to fraud or error and the risk that the auditor would fail to detect that the financial statements are materially misstated. These standards, which the Board adopted as interim auditing standards in 2003, describe in general terms the auditor's responsibilities for assessing and responding to risk, and direct auditors to vary the amount of audit effort related to particular financial statement accounts based on the risks presented by them.^{2/} The standards also allowed the auditor more discretion to

^{1/} See, e.g., AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*.

^{2/} Examples of those standards include AU sec. 312 and AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*.

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use testing of controls as a basis for reducing substantive testing.^{3/} In general terms, these standards require the auditor to use judgment in assessing risks and then in deciding what procedures to perform to respond to those risks.^{4/}

In 1998, at the request of Securities and Exchange Commission ("SEC") Chairman Arthur Levitt, the Public Oversight Board ("POB") appointed the Panel on Audit Effectiveness ("PAE").^{5/} Chaired by Shaun O'Malley, former Chair of Price Waterhouse LLP, the PAE was broadly charged with assessing whether public company audits were adequately serving and protecting the interests of investors.^{6/} To do so, the panel "reviewed and evaluated the way that audits are performed," "assessed recent trends in audit practices to determine whether they are in the public interest," "studied the audit policies, methodologies and other forms of guidance used primarily by the large audit firms, certain aspects of auditor independence and the auditing profession's self-regulatory structure," and "focused on international developments affecting the auditing profession."^{7/}

In its 2000 report, the PAE noted, among many other things, that although auditors had been required to use the "audit risk model"^{8/} since 1984, "anecdotal and other evidence indicates that many (but by no means all) audits continued to be performed using substantive testing approaches with little or no attention paid to the results of the risk assessments called for by the model."^{9/} The PAE also noted, however, that over time, "[t]he sheer volume of transactions processed by client organizations, the fast pace of technological developments affecting client organizations and audit firms alike, and economic constraints on the ability of audit firms to recover rising costs" drove audit firms to evaluate audit effectiveness and efficiency, and to conclude that "many

^{3/} AU sec. 319.

^{4/} Public Oversight Board, Panel on Audit Effectiveness, *Report and Recommendations*, p. 175 (August 31, 2000) ("PAE Report").

^{5/} Letter from Shaun O'Malley, Chair, PAE, to POB and other interested parties (August 31, 2000), included in PAE Report. The POB was a private body that monitored the self-regulatory programs of the SEC Practice Section of the American Institute of Certified Public Accountants ("AICPA"). See also, PAE Report, p.vii. The POB disbanded in 2002.

^{6/} PAE Report p.1.

^{7/} Ibid.

^{8/} The "audit risk model" describes the relationships among the different components of audit risk. See AU sec. 312.

^{9/} PAE Report, p. 178

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audits were being conducted without sufficient consideration being given to the risk assessment process."^{10/} According to the PAE Report, some firms responded to those developments by making changes to their audit methodologies.^{11/} Under newer audit methodologies, auditors take a more comprehensive approach to risk assessment, looking at internal and external factors that affect risks to the financial statements, and they focus their audit procedures on areas with the greatest risks of misstatement.^{12/}

The PAE concluded in its report "that the audit risk model is appropriate, but needs enhancing and updating," and it made several recommendations for doing so.^{13/} In general, the PAE recommended that auditing standards require auditors to have a far deeper understanding of the company's business processes, risks, and controls.^{14/} More specifically, it recommended, among other things, that auditors be required "to make inherent risk assessments for significant account balances and classes of transactions by considering what could go wrong at the individual assertion level,"^{15/} that the Auditing Standards Board of the AICPA ("ASB")^{16/} provide more specific guidance on various aspects of assessing and responding to control risk,^{17/} and that the ASB develop more

^{10/} Ibid.

^{11/} Ibid.

^{12/} See, e.g., "Joint Working Group, Recommendations arising from a study of recent developments in the audit methodologies of the largest accounting firms" (May 2002). The Joint Working Group consisted of standard setters and academics from Canada, the United Kingdom and the United States. Its paper was prepared for submission to the International Auditing Practices Committee, the Assurance Standards Board of the Canadian Institute of Chartered Accountants, the Auditing Practices Board of the United Kingdom and Ireland and the Auditing Standards Board of the AICPA ("ASB").

^{13/} PAE Report, pp. 12-39. 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 E, available at http://www.pcaobus.org/News_and_Events/Events/2005/02-16.aspx.

^{14/} PAE Report, p 15.

^{15/} Ibid, p. 20.

^{16/} Prior to the Sarbanes-Oxley Act of 2002 ("the Act"), the ASB established standards for public company audits.

^{17/} PAE Report, pp. 28-29.

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guidance on "linking the nature, timing, and extent of substantive tests to risk assessments."^{18/}

In a February 2005 meeting, the SAG also considered how the risk assessment process and the Board's related interim standards could be improved. SAG members underscored the importance of considering the risk of fraud during the risk assessment process and of appropriately responding to that risk during the audit. Some SAG members suggested certain procedures for auditors to perform as part of their risk assessment procedures, including reading analysts' reports and other published information about the company being audited, listening to quarterly earnings calls, understanding the compensation arrangements of senior management, and looking at unusual trading activity in the company's stock. In addition, some SAG members emphasized the need for auditors to take an integrated approach to assessing and responding to risk in the integrated audit of the financial statements and internal control over financial reporting, which, at that time, was performed pursuant to Auditing Standard No. 2.

Last year, after notice and comment, the Board replaced Auditing Standard No. 2 with Auditing Standard No. 5.^{19/} Auditing Standard No. 5 describes a risk-based audit of internal control that should be fully integrated with the audit of financial statements. Some commenters on the Board's proposal for Auditing Standard No. 5 expressed concern about the advisability of taking a risk based approach and the adequacy of the Board's interim standards regarding risk assessment. These commenters suggested that auditors have frequently been unsuccessful at applying a risk-based approach to the financial statement audit in the past.^{20/}

^{18/} Ibid, p. 37. In March 2006, the ASB issued a suite of eight risk assessment standards as part of a joint project with the International Audit and Assurance Standards Board ("IAASB") to update and align their risk assessment requirements. The Board's interim auditing standards consist of generally accepted auditing standards, as described in the ASB's Statement of Auditing Standards No. 95, as in existence on April 16, 2003, to the extent not superseded or amended by the Board. As a result, the ASB's 2006 risk assessment standards are not included in the Board's interim standards.

^{19/} Auditing Standard No. 5 became effective for audits of internal control over financial reporting for fiscal years ending on or after November 15, 2007.

^{20/} PCAOB Release No. 2007-005, An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements and Related Independence Rule and Conforming Amendments, (May 24, 2007) p. A4-6.

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The Board considered these comments, but believed that emphasizing risk assessment in the standard would result in more effective and focused audits.^{21/} Accordingly, risk assessment underlies the entire audit process for the audit of internal control over financial reporting under Auditing Standard No. 5.^{22/} While the Board believed (and continues to believe) that auditors can appropriately assess risk under the interim auditing standards, it noted when it adopted Auditing Standard No. 5 that examining the existing standards to see where improvements can be made was one of the Board's highest standard-setting priorities.

The proposed standards are the result of that examination and reflect recommendations of the PAE and the SAG. The Board believes that the proposed standards, if adopted, would result in improvements to audits of issuers in several areas.

First, the proposed standards would update the existing requirements to take account of the improved risk-based audit methodologies currently in use by some auditors. While some firms are already applying many of the procedures described in the proposed standards, the Board believes that improvements in risk assessment methods should be reflected in all public company audits. This does not mean, however, that the Board is proposing a one-size-fits-all approach to risk assessment. The Board recognized in Auditing Standard No. 5 that "[t]he size and complexity of the company...might affect the risks of misstatement and the controls necessary to address those risks."^{23/} Accordingly, the proposed standards describe a risk assessment process that should result in audit procedures tailored to the company's size and complexity.

The proposed standards also reflect the Board's recognition of the importance to the audit process of sound professional judgment. As under the PCAOB's existing auditing standards, auditors would have to exercise professional judgment to determine how best to fulfill the requirements of the proposed standards under particular circumstances. The Board seeks comment on how the proposed standards would change current practice, whether the proposed standards allow sufficient flexibility, and whether they are appropriately scalable.

Second, the proposed standards would serve as an improved foundation for future standard setting. The proposed standards set forth the auditor's responsibilities for certain fundamental aspects of the audit process, such as assessing risk and performing tests of controls and substantive procedures. Future auditing standards that address auditing procedures would build on the foundational principles in the proposed

^{21/} Ibid.

^{22/} Paragraph 10 of Auditing Standard No. 5.

^{23/} Paragraph 13 of Auditing Standard No. 5.

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standards. The Board seeks comment on whether these fundamental principles are articulated appropriately in the proposed standards.

Third, 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 proposed standards describe the auditor's responsibilities for assessing risk, responding to risk, and evaluating audit results in the context of an integrated audit of financial statements and internal control over financial reporting, they include certain foundational risk assessment principles from Auditing Standard No. 5. This should help auditors better understand how certain procedures required by Auditing Standard No. 5 can be integrated with financial statement audit procedures. The Board seeks comment on whether these fundamental principles from Auditing Standard No. 5 have been incorporated appropriately in the proposed standards, whether the proposed standards are appropriately aligned with Auditing Standard No. 5, and, accordingly, whether the proposed standards would improve the effectiveness and efficiency of integrated audits.^{24/}

Fourth, the proposed auditing standards are intended to emphasize the auditor's responsibilities for considering the risk of fraud during the audit. Inspections of registered firms have identified many deficiencies in auditors' compliance with AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, including –

- a tendency to perform the procedures required in AU sec. 316 mechanically, without using the procedures to develop insights on fraud risk or modify the audit plan to address the risk; and
- a failure to respond appropriately to identified fraud risk factors.^{25/}

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 the audit.

^{24/} The Board is not proposing changes to Auditing Standard No. 5, which was adopted last year after notice and comment and approved by the SEC. When considering provisions of the proposed standards that are based upon, or taken from, Auditing Standard No. 5, commenters should focus on whether those provisions are appropriately included in the risk assessment standards.

^{25/} 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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The proposed standards would integrate certain requirements regarding the auditor's consideration of fraud risk, as set forth in AU sec. 316, into the risk assessment standards. This integration would emphasize to auditors that assessing the risk of fraud is a central part of the audit process, rather than a separate consideration. It also should prompt auditors to make a more thoughtful and thorough assessment of the risks affecting the financial statements, including fraud risks, and develop appropriate audit responses. The Board seeks comment on whether the proposed standards focus appropriately on the risk of fraud.

Finally, the proposed standards reflect an effort to eliminate unnecessary differences between the Board's risk assessment standards and other risk assessment standards. The Board believes that such an effort is particularly appropriate in light of the foundational nature of these proposed standards. This effort is in keeping with the Board's strategic plan for 2008-2013, which states the Board's objective to "[p]articipate in the work of, and engage with, other auditing standards-setting bodies to benefit from, and as appropriate incorporate, new developments and techniques to promote high quality audits worldwide."^{26/}

In recent years, the IAASB has updated its auditing standards regarding risk assessment.^{27/} The Board has taken into account the IAASB risk assessment standards in developing these proposals. Specifically, the Board began by considering whether the objectives and requirements of the IAASB's standards are 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 informative, accurate, and independent audit reports."^{28/} While many of the procedures described in the IAASB standards appear to be generally suitable for audits of issuers, the Board believes that certain changes to those standards would be necessary for the Board to adopt them as standards of the PCAOB. Accordingly, there is a degree of commonality between the proposed standards and the IAASB's risk assessment standards, but they do not mirror them word-for-word.

^{26/} PCAOB, Strategic Plan 17 (March 31, 2008), p.17.

^{27/} The IAASB issued its initial risk assessment standards in 2003 and has updated four of its standards related to risk assessment as part of its initiative to enhance the clarity of its standards. The Board understands that the ASB is in the process of a similar initiative.

^{28/} Section 101 of the Sarbanes-Oxley Act of 2002 (the "Act"), 15 U.S.C. § 7211.

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Significant differences between the proposed standards and the IAASB's risk assessment standards are described in Appendix 10. As described more fully in that appendix, these differences generally reflect the need to adapt the IAASB standards for audits of issuers. For example, the Board made changes necessary to make the proposed standards consistent with relevant provisions of the federal securities laws. In addition, consistent with other PCAOB standards, the proposed standards do not include an "Application and Other Explanatory Material" section. That section, included in the IAASB's redrafted International Standards on Auditing ("ISAs"), "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA."^{29/} Rather than including a significant amount of application material in the proposed standards, the Board reviewed the application and other material in the ISAs, adapted those provisions that the Board believed are necessary for audits of issuers, and included them in the proposed standards themselves. Like the rest of the provisions in the proposed standards, the provisions adapted from the ISAs' application material use the terms set forth in Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*, to describe the degree of responsibility imposed on the auditor. The Board also adapted other portions of the ISAs to conform the requirements to the provisions of Rule 3101. Finally, some differences reflect the Board's view that particular procedures described in the ISAs are not necessary for audits of issuers, or that additional procedures not described in the ISAs are necessary.

The Board seeks comment on whether the proposed standards appropriately consider the provisions of the ISAs and whether they reflect necessary differences from risk assessment standards applicable outside the United States.

B. Overview of the Proposed Standards

The proposed risk assessment standards included in this release are as follows:

- *Audit Risk in an Audit of Financial Statements.* This proposed standard describes the components of audit risk and the auditor's responsibilities for reducing audit risk to an appropriately low level in order to obtain reasonable assurance in an audit of financial statements.
- *Audit Planning and Supervision.* This 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 proposed standard also describes the

^{29/} Paragraph A59 of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.*

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responsibilities of the engagement partner and other engagement team members for supervising and reviewing the work of the engagement team.

- *Identifying and Assessing Risks of Material Misstatement.* This proposed standard describes the auditor's responsibilities for identifying and assessing risks of material misstatement. The risk assessment process discussed in the proposed standard includes information-gathering procedures to identify risks (e.g., obtaining an understanding of the company, its environment, and its internal control) and analysis of the identified risks.
- *The Auditor's Responses to the Risks of Material Misstatement.* This proposed standard sets forth the auditor's responsibilities for responding to the risks of material misstatement, including overall responses related to the general conduct of the audit and responses involving specific audit procedures.
- *Evaluating Audit Results.* This proposed standard describes the auditor's responsibilities regarding the process of evaluating the results of the audit in order to form the opinion(s) to be presented in the auditor's report. This process includes evaluating uncorrected misstatements and control deficiencies identified during the audit.
- *Consideration of Materiality in Planning and Performing an Audit.* 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.
- *Audit Evidence.* This proposed standard sets forth the auditor's responsibilities regarding designing and applying audit procedures to obtain sufficient appropriate evidence to support the opinion(s) in the auditor's report. In particular, it discusses the principles for determining the sufficiency and appropriateness of audit evidence.

The proposed standards will supersede five 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*, and AU sec. 326, *Evidential Matter*.

Appendix 9 of this release discusses each of the proposed standards, as well as the proposed conforming amendments to PCAOB standards, in more detail. Appendix 9

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also includes specific questions about the standards for which the Board is requesting comment. The Board requests comment on all aspects of the proposed standards and the conforming amendments to PCAOB interim standards, including, in particular, responses to the questions in Appendix 9.

C. Opportunity for Public Comment

The Board will seek comment on the proposed standards and amendments for a 120-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 February 18, 2009.

* * *

On the 21st day of October, in the year 2008, 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

October 21, 2008

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APPENDICES –

1. *Proposed Auditing Standard – Audit Risk in an Audit of Financial Statements*
2. *Proposed Auditing Standard – Audit Planning and Supervision*
3. *Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement*
4. *Proposed Auditing Standard – The Auditor's Responses to the Risks of Material Misstatement*
5. *Proposed Auditing Standard – Evaluating Audit Results*
6. *Proposed Auditing Standard – Consideration of Materiality in Planning and Performing an Audit*
7. *Proposed Auditing Standard – Audit Evidence*
8. *Proposed Conforming Amendments to PCAOB Standards*
9. *Additional Discussion of Proposed Auditing Standards and Conforming Amendments*
10. *Comparison of Requirements to the Standards of the International Auditing and Assurance Standards Board*

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APPENDIX 1 – PROPOSED AUDITING STANDARD

October 21, 2008
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

Audit Risk in an Audit of Financial Statements

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Audit Risk in an Audit of Financial Statements

Introduction

1. This standard establishes requirements and provides direction regarding the auditor's consideration of audit risk in an audit of financial statements.^{1/}

Note: Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, establishes requirements and provides direction regarding the auditor's consideration of risk in an audit of internal control over financial reporting.

Objective of the Auditor

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 due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care and obtaining sufficient appropriate audit evidence.^{2/}
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. This risk is a function of the risk of material misstatement and detection risk.

^{1/} An audit of financial statements refers to an audit of financial statements as part of an integrated audit and to an audit of financial statements only.

^{2/} 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.

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Risk of Material Misstatement

5. The risk of material misstatement refers to the risk that the financial statements are materially misstated due to error or fraud. 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 and at the financial statement assertion^{3/} level.
6. Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.
7. The risks of material misstatement at the assertion level consist 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, either 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, either individually or in 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, either individually or in combination with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor.

^{3/} See Proposed Auditing Standard, *Audit Evidence*, for a description of financial statement assertions.

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10. The level of detection risk is reduced through the performance of substantive procedures. 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 greater the risk of material misstatement, the less the detection risk that can be accepted. Conversely, the lower the risk of material misstatement, the greater the detection risk that can be accepted.

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APPENDIX 2 – PROPOSED AUDITING STANDARD – AUDIT PLANNING AND SUPERVISION

October 21, 2008
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –
Audit Planning and Supervision

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Audit Planning and Supervision

Introduction

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

Objective of the Auditor

2. The objective of the auditor is to plan the audit and supervise the engagement team so that the audit is conducted effectively.
3. Accordingly, the auditor must adequately plan the audit and properly supervise the members of the engagement team.

Planning an Audit

4. Planning an 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.

Involvement of Key Engagement Team Members in Planning

5. The engagement partner^{1/} is responsible for planning the engagement but may seek assistance from other members of the engagement team.

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/}

^{1/} The term, "engagement partner" refers to the member of the audit engagement team with final responsibility for the audit.

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- 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 determination of compliance are not limited to preliminary engagement activities and could change 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 or other information relevant to identifying risks of material misstatement obtained during other engagements performed by the 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;

^{2/} See 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*.

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- The auditor's preliminary judgments about materiality,^{4/} risk, and other factors relating to the determination of material misstatements and material weaknesses;
- Control deficiencies previously communicated to the audit committee 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.

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:
 - a. Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required by PCAOB standards
 - b. Determine the significant factors that affect the direction of the engagement team

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

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- c. Determine the effects on the audit strategy of 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. Ascertain the nature, timing and extent of resources necessary to perform the engagement.

Audit Plan

- 10. The auditor should develop a written audit plan that should include a description of:
 - a. The planned nature, timing and extent of the risk assessment procedures.^{5/}
 - b. The planned nature, timing and extent of tests of controls and substantive procedures.^{6/}
 - c. Other planned audit procedures that are required to be carried out 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 factors an auditor should evaluate regarding the selection of a particular location or business unit 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,

^{5/} Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

^{6/} Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, and Auditing Standard No. 5.

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- c. The risk of material misstatement to the financial statements associated with the location or business unit,
- d. The degree of centralization of records or information processing,
- e. 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
- f. 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, for considerations when a company has multiple locations or business units.

Changes During the Course of the Audit

12. The auditor should update and change the overall audit strategy and the audit plan as necessary if circumstances change significantly during the course of the audit, e.g., based on a revised assessment of the risks of material misstatement or the discovery of a previously unidentified fraud risk.

Individuals with Specialized Skill or Knowledge

13. 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.
14. In particular, the auditor should determine whether specialized skill or knowledge is needed to evaluate the effect of information technology ("IT") on the audit, to understand the IT controls, or to design and perform tests of IT controls or substantive procedures. Factors that may be relevant to the auditor's determination of the need for specialized IT skills or knowledge include the following:
 - The complexity of the company's systems and IT controls and the manner in which they are used in conducting the company's business

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- The significance of changes made to existing systems or the implementation of new systems
 - The extent to which data is shared among systems
 - The extent of the company's participation in electronic commerce
 - The company's use of emerging technologies
 - The significance of audit evidence that is available only in electronic form
15. If an individual with specialized IT skill or knowledge employed or engaged by the auditor's firm participates in the audit, the auditor should have sufficient IT-related knowledge to enable the auditor to:
- a. Communicate the objectives of that individual's work;
 - b. Evaluate whether that individual's procedures meet the auditor's objectives; and
 - c. Evaluate the results of that individual's procedures as they relate to the nature, timing, and extent of other planned audit procedures.^{7/}

Additional Considerations in Initial Audits

16. 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*.

^{7/} Using the work of a specialist who is, in effect, functioning as a member of the engagement team is not covered by AU sec. 336, *Using the Work of a Specialist*. An individual with specialized IT skill or knowledge requires the same supervision as any member of the engagement team.

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17. 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 whether it is necessary to expand the planning activities to establish an appropriate audit strategy and audit plan, e.g., to determine the audit procedures necessary to obtain sufficient appropriate audit evidence regarding the opening balances.

Supervision

18. The engagement partner should supervise other engagement team members, but he or she may seek assistance from appropriate engagement team members in fulfilling these supervisory responsibilities.
19. Supervision should include the following:
 - a. Informing other 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, such as the nature of the company's business as it relates to their assignments and possible accounting and auditing issues;
 - b. Directing other 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; and
 - c. Reviewing the work of other engagement team members to determine whether the work was performed and documented and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report.
20. The level of supervision of other engagement team members should be appropriate for the circumstances, including:
 - 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

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- The risks of material misstatement^{8/}
 - The capabilities and competence of the individual team members performing the audit work
21. 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. Such procedures should enable an engagement team member to document his or her disagreement with the conclusions reached in the resolution of the matter. In this situation, the basis for the final resolution also should be documented.^{9/}

^{8/} Paragraph 4b 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.

^{9/} See also paragraph 12d of Auditing Standard No. 3, *Audit Documentation*.

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APPENDIX 3 – PROPOSED AUDITING STANDARD

October 21, 2008

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

Identifying and Assessing Risks of Material Misstatement

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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 5-55 describe risk assessment procedures for obtaining information necessary to identify and assess risks of material misstatement. Paragraphs 56-64 explain how to identify and assess the risks of material misstatement using information obtained from the risk assessment procedures.

Objective of the Auditor

3. The objective of the auditor is to identify and appropriately assess the risks of material misstatement.

Definitions

4. For purposes of this standard, the terms listed below are defined as follows:
 - a. 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.^{2/}
 - b. Significant risk – A risk of material misstatement that is important enough to require special audit consideration.

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

^{2/} Risk assessment procedures by themselves do not provide sufficient appropriate evidence on which to base an audit opinion.

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Performing Risk Assessment Procedures

5. The auditor should perform risk assessment procedures to obtain sufficient appropriate evidence to identify and appropriately assess the risks of material misstatement due to error or fraud^{3/} and to design further audit procedures.^{4/}
6. The auditor's risk assessment procedures should include the following:
 - a. Obtaining an understanding of the company and its environment;
 - b. Obtaining an understanding of internal control over financial reporting;^{5/}
 - c. Considering information from the client acceptance and retention evaluation, past audits, and other engagements;
 - d. Performing analytical procedures;
 - e. Conducting a discussion among engagement team members regarding the risks of material misstatement; and
 - f. Inquiring of the audit committee, management, and others within the company about the risks of material misstatement.
7. 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. Accordingly, 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.

^{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*, defines further audit procedures as tests of controls and substantive procedures.

^{5/} See A5 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements*, for a definition of "internal control over financial reporting" and a discussion of the inherent limitations of internal control over financial reporting.

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Obtaining an Understanding of the Company and Its Environment

8. 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.
9. The auditor's understanding of the company should include the following:
 - a. Relevant industry, regulatory, and other external factors;
 - b. The nature of the company;
 - c. The company's objectives and strategies and those related business risks that might reasonably be expected to result in risks of material misstatement;
 - d. The company's measurement and review of its financial performance; and
 - e. The company's selection and application of accounting policies, including the reasons for changes thereto.
10. 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.

Industry, Regulatory, and Other External Factors

11. Industry, regulatory, and other external factors that are relevant to the auditor's understanding of the company include industry factors such as the competitive environment and technological developments; the regulatory environment, including the applicable financial reporting framework^{6/} and the legal and political environment;^{7/} and other external factors such as general economic conditions.

^{6/} 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.

^{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.

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Nature of the Company

12. Obtaining an understanding of the nature of the company includes obtaining an understanding of 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 investments;
 - The company's operating characteristics, including its size and complexity;^{8/}
 - The sources of the company's earnings, including the relative profitability of key products and services; and
 - Key supplier and customer relationships.

Note: The auditor should take into account the information obtained 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*.

13. 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;^{9/}
 - Observing or reading transcripts of earnings calls;

^{8/} The size and complexity of a company might affect the risks of misstatement and how the company addresses those risks. The note to paragraph 9 of Auditing Standard No. 5 discusses factors that might indicate less complex operations.

^{9/} Paragraph 7 of Proposed Auditing Standard, *Audit Planning and Supervision*.

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- Obtaining information about significant unusual developments regarding trading activity in the company's securities; and
- Obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements; changes or adjustments to those arrangements and special bonuses.

Company Objectives, Strategies, and Related Business Risks

14. The purpose of obtaining an understanding of the company's objectives, strategies,^{10/} and related business risks^{11/} 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 business risks that might be relevant to the auditor's consideration of the company's, strategies and related business risks –
 - 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).
 - Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
 - New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).
 - Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).

^{10/} For purposes of this standard, objectives refer to 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.

^{11/} Business risks 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.

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- 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).
- Use of IT (a potential related business risk might be, for example, that systems and processes are incompatible).
- 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).

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 the company uses to monitor its operations when such monitoring procedures (a) are sufficiently precise to prevent or detect misstatements that could result in material misstatement of the financial statements and (b) have effective controls over the accuracy of the measures

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.

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Selection and Application of Accounting Principles

18. As part of obtaining an understanding of the company's selection and application of accounting principles, 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.
19. The auditor should obtain an understanding of the following matters, if applicable, in obtaining an understanding of the company's selection and application of accounting principles:
 - 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, especially those used for determining management's estimates and assumptions
 - The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus
 - The degree of transparency of the application of significant accounting principles and related financial reporting processes
 - Significant changes in the company's accounting and financial reporting policies and disclosures and the reasons for such changes
 - Financial reporting standards and laws and regulations that are new to the company and when and how the company will adopt such requirements
 - The financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles

Obtaining an Understanding of Internal Control Over Financial Reporting

20. The auditor should obtain a sufficient understanding of each component 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.

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21. 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;^{12/} the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's controls, including the company's use of information technology 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. For example, if the auditor plans to use information produced by the company, he or she should obtain an understanding of controls over the completeness and accuracy of that information if necessary to evaluate the sufficiency and appropriateness of the information.^{13/}

22. In obtaining an understanding of internal control, the auditor should evaluate the design of controls and determine whether the controls have been implemented.

Note: In evaluating the design of controls, the auditor should apply the direction provided in paragraphs 21-22 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

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.

^{12/} Paragraph 13 of Auditing Standard No. 5 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."

^{13/} Paragraph 10 of Proposed Auditing Standard, *Audit Evidence*.

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Components of Internal Control Over Financial Reporting

23. Internal control over financial reporting can be described as consisting of the following components:^{14/}

- The control environment
- The company's risk assessment process
- The information system relevant to financial reporting and communication
- Control activities
- Monitoring of controls

24. In an audit of financial statements only, the auditor may use an internal control framework with components that are different from the components identified in the preceding paragraph provided the framework is a suitable, recognized framework.^{15/} Paragraph 5 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements*, states that, in an integrated audit:

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.^{16/}

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 25 - 36 of this standard to conform to the components in the framework used.

^{14/} Different internal control frameworks use different terms and approaches to describe the components of internal control over financial reporting.

^{15/} See Securities Exchange Act Release No. 34-47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

^{16/} Footnote 7 of Auditing Standard No. 5.

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Control Environment

25. 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.

Note: In an integrated audit, the auditor's procedures for obtaining an understanding of the control environment might be performed as part of the evaluation of entity-level controls, as discussed in paragraphs 22-24 of Auditing Standard No. 5.

26. While obtaining an understanding of the control environment, the auditor should assess –

- 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 25, 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.

27. 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 58-60.

The Company's Risk Assessment Process

28. 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"),

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- b. Assessing the likelihood and significance of misstatements resulting from those risks, and
- c. Deciding about actions to address those risks.

Note: In an integrated audit, the auditor's procedures for obtaining an understanding of the company's risk assessment process might be performed in conjunction with the evaluation of entity-level controls, as discussed in paragraphs 22-24 of Auditing Standard No. 5.

Information System Relevant to Financial Reporting and Communication

29. *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 IT 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,^{17/} that are significant to the financial statements; and
 - e. The period-end financial reporting process.
30. *Business Processes.* A company's business processes are the activities designed to:
- a. Develop, purchase, produce, sell and distribute a company's products and services;

^{17/} Examples of such events and conditions include depreciation and amortization and conditions affecting the recoverability of assets.

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- b. Ensure compliance with laws and regulations relevant to the financial statements; and
 - c. Record information, including accounting and financial reporting information.
31. Business processes result in the transactions that are recorded, processed and reported by the information system. Obtaining an understanding of the company's business processes, which include how transactions are originated, assists the auditor in obtaining an understanding of the company's information system relevant to financial reporting in a manner that is appropriate to the company's circumstances.
32. *Period-end Financial Reporting Process.* The company's period-end financial reporting process, as referred to in paragraph 29e, includes the following:
- Procedures used to enter transaction totals into the general ledger;
 - Procedures related to the selection and application of accounting policies;^{18/}
 - 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 the audit is an integrated audit); and
 - Procedures for preparing annual financial statements and related disclosures (and quarterly financial statements, if the audit is an integrated audit).

Note: In an integrated audit, the auditor's procedures for obtaining an understanding of the company's monitoring activities might be performed in conjunction with the evaluation of entity-level controls, as discussed in paragraphs 26-27 of Auditing Standard No. 5.

^{18/} See paragraphs 18-19 of this standard.

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33. *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;
- Communications to external parties, including regulatory authorities and shareholders.

Note: In an integrated audit, the auditor's procedures for obtaining an understanding of how the company communicates financial reporting roles and responsibilities and significant matters relating to financial reporting might be performed in conjunction with the evaluation of entity-level controls, as discussed in paragraphs 22-24 of Auditing Standard No. 5.

Control Activities

34. 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 20.

Note: For purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than that which is normally obtained in an audit of financial statements only.

Monitoring of Controls

35. The auditor should obtain an understanding of the types of major 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 an integrated audit, the auditor's procedures for obtaining an understanding of the company's monitoring activities might be performed in conjunction with the evaluation of entity-level controls, as discussed in paragraphs 22-24 of Auditing Standard No. 5.

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36. An understanding of the company's monitoring activities^{19/} should include understanding the source of the information used in the monitoring activities.

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

37. *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 56-63 of this standard.
38. *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 e.g., in determining how changes in the company or its environment affect the risks of material misstatement, as discussed in paragraph 10 of this standard.
39. If the auditor plans to modify the nature, timing, or extent of his or her risk assessment procedures based on information from past audits, the auditor should determine that the prior-year's information is relevant.
40. *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 review is relevant to identifying risks of material misstatement in the year-end audit.
41. The auditor should assess whether information obtained in other engagements performed by the auditor is likely to be important for identifying risks of material misstatement.^{20/}

^{19/} AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, describes the auditor's responsibilities regarding obtaining an understanding of a company's monitoring activities involving the company's internal audit function.

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

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Note: In multi-location engagements in which certain components are audited by affiliated firms, this might be accomplished through communications between the engagement partner and those responsible for the audits of components.

Performing Analytical Procedures

42. 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 last audit date; and
 - b. Identify areas that might represent specific risks relevant to the audit, such as, the existence of unusual transactions and events, and amounts, ratios, and trends that warrant investigation.
43. 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 due to fraud. Also, when the auditor has performed a review of interim financial information in accordance with AU sec. 722, *Interim Financial Information*, he or she should take into account the analytical procedures applied in that review when designing and applying analytical procedures as risk assessment procedures.
44. 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 unusual or unexpected results, the auditor should take into account those results in identifying the risks of material misstatement.

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

45. The key engagement team members should discuss (1) the susceptibility of the company's financial statements to material misstatement due to error or fraud

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

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and (2) the application of the applicable financial reporting framework to the company's facts and circumstances.

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 48-49 of this standard.

46. 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.

47. Communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit when conditions change.^{22/}

Discussion of the Potential for Material Misstatement Due to Fraud

48. The discussion among the engagement team members about the potential for material misstatement due to fraud should occur with an attitude that includes a questioning mind, and the engagement team members should set aside any prior beliefs they might have that management is honest and has integrity. The discussion among the engagement team members should include –
- An exchange of ideas or "brainstorming" among the 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

^{22/} See also paragraph 31 of Proposed Auditing Standard, *Evaluating Audit Results*.

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and conceal fraudulent financial reporting, and how assets of the company could be misappropriated

- 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
- Communication about the potential audit responses to the susceptibility of the company's financial statements to material misstatement due to fraud

49. The following matters should be emphasized 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 AU sec. 316.13
- The need to be alert for information or other conditions (such as those presented in paragraph B1 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

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

50. 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.

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51. 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.

Inquiries Regarding Fraud Risks

52. 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; and
 - (6) 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 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;

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- (3) How the audit committee exercises oversight of the company's assessment of the risks of fraud; and
 - (4) If the audit committee assumes an active role in the oversight of the company's assessment of fraud risks and mitigating controls, the audit committee's views regarding fraud risks and the 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; and
 - (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.
 - d. Inquiries of accounting and financial reporting personnel, including, in particular, employees involved in initiating, authorizing, processing, or recording complex or unusual transactions regarding—
 - (1) The employee's views as to whether accounting policies were appropriately or aggressively applied;
 - (2) The employee's views about the risks of fraud;
 - (3) Whether the employee has knowledge of fraud, alleged fraud, or suspected fraud affecting the company; and
 - (4) Whether the employee is aware of instances of management override of controls and the nature and circumstances of such overrides.
- 53. In addition to the inquiries outlined in the preceding paragraph, the auditor should inquire of others within the company about whether they have knowledge of fraud, alleged fraud, or suspected fraud.

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54. In determining the individuals within the company to whom inquiries should be directed in applying paragraphs 52d and 53, the auditor should assess who might reasonably be expected to have information that is important to the identification and assessment of fraud risks, e.g., individuals who 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.
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 the risks of material misstatement due to errors or fraud using information obtained from the risk assessment procedures and considering the characteristics of the accounts and disclosures in the financial statements.^{23/}
 - 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 of material misstatement at the assertion level, the auditor should evaluate whether the risks of material misstatement at the financial statement level could result in 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

^{23/} See paragraphs 58-62 for a discussion of factors related to the identification of fraud risks.

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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.^{24/}

- e. Identify significant accounts and disclosures and their relevant assertions.

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. Refer to paragraphs 28-33 of Auditing Standard No. 5 for additional discussion of identifying significant accounts and disclosures and their relevant assertions.

- f. Determine whether any of the identified risks are significant risks.

Note: The determination of whether a risk of misstatement is a significant risk is based on inherent risk, without regard to the effect of controls. (See paragraph 63 for a discussion of factors relevant to identifying significant risks.)

- 57. For the audit of internal control over financial reporting, paragraph 34 of Auditing Standard No. 5 sets forth certain objectives that the auditor should achieve to further understand the likely sources of potential misstatements and as part of selecting the controls to test. The auditor should take into account the evidence obtained from the procedures performed to achieve the objectives in paragraph 34 of Auditing Standard No. 5 when identifying risks of material misstatement and designing further audit procedures in the audit of financial statements.

Factors Relevant to Identifying Fraud Risks

- 58. 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

^{24/} See paragraphs 18-19 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

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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.

59. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are listed in paragraph 85 of AU sec. 316 *Consideration of Fraud in a Financial Statement Audit*. 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 list of fraud risk factors in AU sec. 316.85 covers a broad range of situations and are only examples. Accordingly, the auditor might identify additional or different fraud risk factors.

60. The auditor should not assume that all of the conditions discussed in the preceding paragraph 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 the three conditions is present.
61. *Presumption of Fraud Risk Involving Improper Revenue Recognition*. The auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate the types of revenue or revenue transactions to which the risk relates.
62. *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.

Factors Relevant to Identifying Significant Risks

63. 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;

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- 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 size or nature.

Further Consideration of Controls

64. 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 20-36 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.

65. Controls that address fraud risks include (a) specific controls designed to mitigate specific risks of fraud, e.g., controls to address risks of misappropriation of specific assets and (b) controls designed to prevent, deter, and detect fraud, e.g., controls to promote a culture of honesty and ethical behavior.^{25/} Such controls also include those that address the risk of management override of other controls.

Revision of Risk Assessment

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 should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.

^{25/} See AU sec. 316.88 and paragraph 14 of Auditing Standard No. 5.

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APPENDIX A – Consideration of Manual and Automated Systems and Controls

- A1. 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 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. That information should be taken into account in assessing the risks of material misstatement.

Note: Paragraphs 13-15 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 an individual with specialized IT knowledge and skills employed or engaged by the auditor's firm.

- A2. Controls in a manual system might include procedures such as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items.
- A3. 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.
- A4. 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

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- 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
- A5. 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.
- A6. 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.

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APPENDIX 4 – PROPOSED AUDITING STANDARD

October 21, 2008
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

The Auditor's Responses to the Risks of Material Misstatement

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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.
2. In particular, 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 4-5.
 - b. Responses involving the nature, timing, and extent of the audit procedures to be performed, as described in paragraphs 6-50.

Objective of the Auditor

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

Overall Responses

4. The auditor should design and implement overall responses to address the 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 risks of material misstatement.
 - b. *Providing an appropriate level of supervision,* as described in paragraphs 18-21 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 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

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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.

- e. *Making general changes to the nature, timing, or extent of audit procedures.* The auditor should evaluate whether it is necessary to make general changes to the nature, timing, or extent of audit procedures to adequately address the risks of material misstatement.
5. 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.^{2/} 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 fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining additional corroboration of management's explanations or representations concerning important matters, such as through third-party

^{1/} Paragraphs 18-19 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.

^{2/} Paragraph .13 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

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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

6. The auditor should design and perform audit procedures the nature, timing, and extent of which are based on and address the risks of material misstatement for each relevant assertion of each significant account and disclosure.
7. 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.
 - b. Take into account the types of potential misstatements that could result from the identified risks and the likelihood and magnitude of potential misstatement.
 - 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^{3/} assessments for purposes of the audit of the financial statements;^{4/} and
 - (2) To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year end.
8. The audit procedures performed in response to the risks of material misstatement can be classified into two categories – tests of controls and

^{3/} See paragraph 7b of Proposed Auditing Standard, *Audit Risk in an Audit of Financial Statements*, for a definition of control risk.

^{4/} 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.

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substantive procedures.^{5/} Paragraphs 14-39 of this standard discuss tests of controls, and paragraphs 40-50 discuss substantive procedures.

Responses to Fraud Risks

9. As part of the responses involving the nature, timing, and extent of audit procedures discussed in paragraphs 6-8 of this standard, the auditor should design and perform audit procedures the nature, timing, and extent of which address the fraud risks. The audit procedures that are necessary to address fraud risks depend upon the types of risks and the relevant assertions that might be affected.

Note: During the audit of internal control or the audit of the financial statements, if the auditor identifies deficiencies in controls that are intended to address fraud risks, the auditor should take into account those deficiencies when developing his or her response to fraud risks.

10. *Addressing Fraud Risks in the Audit of Internal Control.* When planning and performing the audit of internal control over financial reporting ("audit of internal control"), the auditor should take into account the results of his or her fraud risk assessment. As part of identifying and testing entity-level controls and selecting other controls to test, the auditor should evaluate whether the company's controls sufficiently address identified fraud risks and controls intended to address the risk of management override of other controls.^{6/}
11. *Addressing Fraud Risks in the Audit of Financial Statements.* In the audit of the financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the fraud risks. The auditor also may perform tests of controls intended to address fraud risks that are selected for testing in accordance with paragraphs 18-19 of this standard.
12. The following are examples of ways in which planned audit procedures may be modified to address fraud risks:

^{5/} Substantive procedures consist of (a) tests of details of accounts and disclosures and (b) substantive analytical procedures.

^{6/} Paragraph 14 of Auditing Standard No. 5 and paragraph 65 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

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- 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: AU secs. 316.53-.66, provide further examples of and additional direction on responses to identified fraud risks relating to fraudulent financial reporting (e.g., revenue recognition, inventory quantities, and management estimates) and misappropriation of assets in the audit of the financial statements.

13. 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 Internal Control⁷¹

14. *Objective of Tests of Controls.* The objective of the tests of controls in an audit of internal control under Auditing Standard No. 5 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

⁷¹ See Auditing Standard No. 5 for further discussion of the auditor's responsibilities for testing controls in the audit of internal control.

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effectiveness of the company's internal control over financial reporting as of a point in time and taken as a whole.^{8/}

15. *Controls to Be Tested.* To express an opinion on internal control over financial reporting taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant assertions. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.^{9/}

Note: In the audit of internal control, the auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting. The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.^{10/} Entity-level controls vary in nature and precision.^{11/}

Note: Refer to paragraphs 39-41 of Auditing Standard No. 5 for additional discussion of selection of controls to test in an audit of internal control.

16. *Evidence about the Effectiveness of Controls in the Audit of Internal Control.* For each control selected for testing in the audit of internal control, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.^{12/}

^{8/} Paragraph B1 of Auditing Standard No. 5.

^{9/} Paragraph B2 of Auditing Standard No. 5.

^{10/} Paragraph 22 of Auditing Standard No. 5.

^{11/} Paragraph 23 of Auditing Standard No. 5. See paragraphs 23 -27 of Auditing Standard No. 5 for further direction regarding the evaluation of entity-level controls.

^{12/} Paragraph 46 of Auditing Standard No. 5.

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Note: Paragraphs 46-48 of Auditing Standard No. 5 provide additional direction regarding the risk associated with a control.

Testing Controls in an Audit of Financial Statements

17. *Objective of Tests of Controls.* The objective of the tests of controls in an audit of financial statements is to obtain sufficient evidence to support the auditor's control risk assessments.
18. *Controls to be Tested.* If the auditor assesses the risk of material misstatement below the maximum level because of reliance on controls,^{13/} and the nature, timing, and extent of 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.^{14/}
19. Also, tests of controls should 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 substantive analytical procedures.^{15/}
20. *Evidence about the Effectiveness of Controls in the Audit of Financial Statements.* In designing and performing tests of controls for the audit of the financial

^{13/} As discussed in Proposed Auditing Standard, *Audit Risk in the Audit of Financial Statements*, the risk of material misstatement is a function of inherent risk and control risk. Reliance on controls, when appropriate, allows the auditor to assess control risk below the maximum, which results in a lower assessed risk of material misstatement. In turn, this might allow the auditor to modify the nature, timing, and extent of planned substantive procedures.

^{14/} The term "period of reliance" refers to 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.

^{15/} Paragraph .16 of AU sec. 329, *Substantive Analytical Procedures*, states, "Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information."

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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 evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. The auditor 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, as, e.g., in situations in which it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

Testing Design Effectiveness

21. 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 errors or fraud that could result in material misstatements in the financial statements.
22. 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.^{16/}

Testing Operating Effectiveness

23. 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.
24. 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.^{17/}

^{16/} Paragraphs 37-38 of Auditing Standard No. 5 provide direction on performing a walkthrough.

^{17/} Refer to the Note to paragraph 49 of Auditing Standard No. 5 for discussion of using walkthroughs to obtain evidence of operating effectiveness in the audit of internal control over financial reporting.

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Obtaining Evidence from Test of Controls

25. 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 risk associated with the control in an audit of internal control or with 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

26. 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.

27. 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.

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Extent of Tests of Controls

28. The more extensively a control is tested, the greater the evidence obtained from that test.
29. Matters that could affect the necessary extent of testing of a control in relation to the risk associated with a control, or the degree of reliance on a control in a financial statement audit, 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

30. The necessary timing of tests of controls depends on the objective of the test of controls, as discussed in paragraphs 14 and 17 of this standard.
31. In the audit of internal control, the auditor should balance performing the tests of controls closer to the as-of date with the need to test controls over a sufficient period of time to obtain sufficient evidence of operating effectiveness. Testing controls over a greater period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Testing

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performed closer to the date of management's assessment provides more evidence than testing performed earlier in the year.^{18/}

32. *Obtaining Evidence about Changes in Controls.* Prior to the period-end date (or the date specified in management's assessment), management might implement changes to the company's controls to make them more effective or efficient or to address deficiencies in internal control over financial reporting.^{19/} If the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, he or she will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting.^{20/}
33. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment, the auditor should test the design and operating effectiveness of those superseded controls, as appropriate.
34. *Using Audit Evidence Obtained during an Interim Period.* When the auditor obtains evidence about the operating effectiveness of controls at an interim date in an audit of internal control or through an interim date in an audit of financial statements, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.
35. 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 specific control tested prior to year-end, including the risks associated with the control and the nature of the control, and the results of those tests;
 - The sufficiency of the evidence of effectiveness obtained at an interim date;
 - The length of the remaining period; and

^{18/} Paragraph 52 of Auditing Standard No. 5.

^{19/} See paragraph A3 of Auditing Standard No. 5 for a definition of "deficiency" in internal control over financial reporting.

^{20/} Paragraph 53 of Auditing Standard No. 5.

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- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

Note: In some circumstances, such as when evaluation of the foregoing factors indicates a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be sufficient as a roll-forward procedure.

36. *Using Audit Evidence Obtained in Past Audits.* For audits of internal control, paragraphs 57- 61 of Auditing Standard No. 5 provide direction on incorporating knowledge obtained during past audits and determining the effect of that knowledge on the necessary nature, timing, and extent of testing of controls.
37. For audits of financial statements, the auditor should obtain evidence about the design and operating effectiveness of controls selected for testing in the current year audit. When controls have been tested in past audits, the auditor should take into account the following factors to determine the evidence needed in the current year audit to support the auditor's control risk assessments:
- The inherent risk associated with the related account(s) or assertion(s)
 - The nature of the controls and the frequency with which they operate
 - 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)
 - The planned degree of reliance on the controls
 - 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

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Assessing Control Risk

38. In the audit of the financial statements, the auditor should assess control risk at the assertion level 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 the financial statements, misstatements detected during the financial statement audit, and any identified control deficiencies.
39. When deficiencies affecting the controls upon which the auditor intends to rely are detected, the auditor should evaluate the severity of the deficiencies and their potential consequences and should determine whether:
- a. Additional tests of controls (e.g., tests of compensating controls) are necessary; or
 - b. The degree of reliance on controls needs to be reassessed and the planned substantive procedures need to be modified as necessary if the assessed risk of material misstatement is increased.

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.

Substantive Procedures

40. The auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.
41. In accordance with paragraph 7a of this standard, as the risk of material misstatement increases, the evidence 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 evidence to respond to the risk of material misstatement.

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Note: 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.^{21/}

Nature of Substantive Procedures

42. 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 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.

43. The auditor should take into account the types of potential misstatements in the relevant assertions that could result from the identified risks when determining the types and combination of substantive audit procedures that are necessary to respond to the risks of material misstatement. Considering the types of potential misstatements can help the auditor design and perform audit procedures to detect those misstatements.
44. *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.

^{21/} Paragraph .44 of AU sec. 350, *Audit Sampling*, discusses applying audit sampling in dual-purpose tests.

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

45. *Substantive Procedures Responsive to Significant Risks*. For significant risks,^{22/} the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the risks.

Note: Paragraphs 9-13 of this standard discuss the auditor's responses to fraud risks. Paragraph 63 of Proposed Auditing Standard, *Identifying and Assessing the Risks of Material Misstatement*, discusses identification of significant risks.

Extent of Substantive Procedures

46. The more extensively a substantive procedure is performed, the greater the evidence obtained from the procedure. The extent of a substantive audit procedure that is necessary depends on the materiality of the account or disclosure, the risk of material misstatement, and the degree of assurance the auditor plans to obtain from the procedure. However, increasing the extent of an audit procedure cannot adequately address a risk of material misstatement unless the evidence to be obtained from the procedure is reliable and relevant.

Timing of Substantive Procedures

47. 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.
48. In determining whether it is appropriate to perform substantive procedures at an interim date, the auditor should take into account the following:
- a. The risk of material misstatement, including:

^{22/} Paragraph 4a of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

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- (1) The auditor's assessment of control risk
 - (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.
49. 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.
50. If the auditor misstatements that he or she did not expect when assessing the risks of material misstatement detects, the auditor should evaluate whether the related assessment of risk and the planned nature, timing, or extent of substantive procedures covering the remaining period need to be modified. Examples of such modifications include extending or repeating at the period end the procedures performed at the interim date.

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APPENDIX 5 – PROPOSED AUDITING STANDARD

October 21, 2008
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –
Evaluating Audit Results

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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 of the Auditor

2. The objective of the auditor is to evaluate the results of the audit to form the opinion to be expressed in the auditor's report.

Definitions

3. For purposes of this standard, the terms listed below are defined as follows:
 - a. Error – An unintentional misstatement in the financial statements.
 - b. 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.^{1/} 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.
 - c. Uncorrected misstatements – Misstatements accumulated during the audit that management has not corrected.

Evaluating the Results of the Audit of Financial Statements

4. In forming an opinion on the financial statements, the auditor should evaluate all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.

^{1/} 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.

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5. In the audit of the financial statements,^{2/} the auditor's evaluation of audit results should include evaluation of the following:
- a. The results of analytical procedures in the overall review of the financial statements ("overall review");
 - b. Identified misstatements;
 - 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

6. In the overall review, the auditor should read the financial statements and disclosures 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.
7. In particular, the auditor should evaluate whether
- a. The 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^{3/} indicate risks of material misstatement that were not identified previously.

^{2/} 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.

^{3/} Paragraph 44 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

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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.

8. The nature, timing, and extent of the analytical procedures that should be performed during the overall review depend on the nature of the company and its industry. These procedures should include analytical procedures relating to revenue through the end of the reporting period.^{4/}
9. *Evaluating Whether Analytical Procedures Indicate a Previously Unrecognized Fraud Risk*. The auditor should evaluate whether analytical procedures performed as part of the overall review result in the identification of unusual or unexpected relationships that indicate a fraud risk that was not identified previously.
10. Whether an unusual or unexpected relationship is a fraud risk 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 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.
11. The auditor should 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.

Accumulating and Evaluating Identified Misstatements

12. *Accumulating Identified Misstatements*. The auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial.
13. 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

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

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financial statements, individually or in combination with other misstatements, considering the possibility of undetected misstatement.

14. 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. To evaluate the effects of identified misstatements and communicate them to management and the audit committee, the auditor may distinguish specifically identified misstatements, projected misstatements from substantive audit sampling,^{5/} and misstatements related to accounting estimates that are outside of a reasonable range.^{6/}
15. *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 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 misstatements approaches the materiality level used in planning and performing the audit, there likely will be a greater than an appropriately low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, 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.

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

^{5/} AU sec. 350, *Audit Sampling*.

^{6/} Paragraph 28 of this standard.

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

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17. 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.
18. *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 and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.

Note: If the financial statements contain material misstatements, the auditor should issue a qualified or an adverse opinion on the financial statements.^{8/}
19. The auditor should evaluate the effects of uncorrected misstatements detected in prior years on the accounts and disclosures, and the financial statements as a whole.
20. The auditor cannot assume that an instance of error or fraud is an isolated occurrence. Therefore, the auditor should evaluate the effects of the accumulated misstatements on the assessed risks of material misstatement. This evaluation is important in determining whether the risk assessments remain appropriate, as discussed in paragraph 38 of this standard.
21. *Evaluating Misstatements that Might Be Indicative of Fraud.* The auditor should 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. 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.
22. 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.

^{8/} AU sec. 508, *Reports on Audited Financial Statements*.

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23. 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. For example, 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.
24. 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 sec. 316, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1.

Evaluating the Qualitative Aspects of the Company's Accounting Practices

25. When evaluating whether the financial statements as a whole are free of material misstatement, the auditor should assess the qualitative aspects of the company's accounting practices, including possible bias in management's judgments about the amounts and disclosures in the financial statements.
26. The following are examples of forms of management's bias that, if present, the auditor should assess in his or her evaluation of the qualitative aspects of the company's accounting practices:
 - 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 16.

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- b. Bias in the selection and application of accounting principles.^{9/}
 - c. Bias in accounting estimates.^{10/}
27. If the auditor identifies potential bias in management's judgments about the amounts and disclosures in the financial statements, he or she should evaluate whether circumstances producing such a bias represent a risk of a material misstatement due to fraud.
28. *Assessing Bias in 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 accordance with the applicable accounting principles, he or she should treat the difference between that estimate and the closest reasonable estimate as a misstatement.
29. If an accounting estimate is determined in accordance 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.^{11/} However, 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. For example, 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 re-assess the estimates taken as a whole.

Note: AU secs. 316.63-.65 provide additional direction regarding the auditor's consideration of bias in accounting estimates.

^{9/} Paragraph 5d of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

^{10/} Paragraphs 28 - 29 of this standard.

^{11/} Paragraph .14 of AU sec. 342, *Auditing Accounting Estimates*.

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Evaluating Conditions Relating to the Assessment of Fraud Risks

30. When evaluating the results of the audit, the auditor should evaluate whether the accumulated results of auditing procedures^{12/} and other observations affect the assessment of the fraud risks made earlier in the audit and the need to modify the audit procedures to respond to those risks.
31. 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.^{13/}
32. The auditor's assessment of fraud risks should be ongoing throughout the audit. (See Appendix A.)

Evaluating the Presentation of the Financial Statements, Including the Disclosures

33. The auditor must evaluate whether the financial statements, including the related disclosures, are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

Note: AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, and AU sec. 431, *Adequacy of Disclosure in Financial Statements*, provide additional direction on evaluating the presentation of the financial statements and the adequacy of the financial statement disclosures, respectively. Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, provides direction on evaluating the consistency of the accounting principles used in financial statements.

^{12/} Examples of such auditing procedures include procedures in the overall review (paragraphs 9 - 11 of this standard), the evaluation of identified misstatements (paragraphs 21 -24 of this standard), and the evaluation of the qualitative aspects of the company's accounting practices.

^{13/} To accomplish this communication, the engagement partner might arrange another discussion among the audit team members about fraud risks. (See paragraphs 45 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.)

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Evaluating the Sufficiency and Appropriateness of Audit Evidence

34. Paragraph 3 of Proposed Auditing Standard, *Audit Risk in an Audit of Financial Statements*, 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 and obtaining sufficient appropriate audit evidence.

35. 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.
36. 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. Paragraphs 15 and 18-20 of this standard.
 - 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 21-24 and 30-32 of this standard.
 - c. The auditor's risk assessments. (See paragraph 38 of this standard.)
 - d. The results of audit procedures performed in the audit of internal control over financial reporting, if the audit is an integrated audit. (See paragraphs 39-40 of this standard.)
 - e. The relevance and reliability of the audit evidence obtained.^{14/}

^{14/} Paragraphs 7-9 of Proposed Auditing Standard, *Audit Evidence*, discuss the relevance and reliability of audit evidence.

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37. If the auditor has not obtained sufficient appropriate audit evidence, the auditor should attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should express a qualified opinion or a disclaimer of opinion.^{15/}
38. *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: Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, provides further direction on revising the auditor's risk assessment.
39. *Effect of Results of the Audit of Internal Control on Risk Assessments.* In an integrated audit, when concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the company's internal control over financial reporting. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.
40. If, during the audit of internal control over financial reporting, the auditor identifies a control deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.^{16/}

^{15/} AU sec. 508, *Reports on Audited Financial Statements*.

^{16/} Paragraph 39 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

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

Forming an Opinion on the Effectiveness of Internal Control Over Financial Reporting

41. In accordance with Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements*, 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.
42. Auditing Standard No. 5 describes the auditor's responsibilities regarding evaluating the results of the audit, including evaluating the identified control deficiencies.^{17/}

Effect of Financial Statement Audit on the Conclusion About the Effectiveness of Internal Control Over Financial Reporting

43. The auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting.^{18/}
44. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on internal control over financial reporting, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements.^{19/}

Note: Also, reevaluation of the auditor's risk assessments, as discussed in paragraph 38, could affect the audit of internal control over financial

^{17/} For example, 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.

^{18/} Paragraph B8, Auditing Standard No. 5.

^{19/} Paragraph B3, Auditing Standard No. 5.

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reporting, e.g., if it results in the identification of relevant assertions that were not identified previously.

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Appendix A – Matters That Might Affect the Assessment of Fraud Risks

- A1. If matters such as the following are identified during the audit, the auditor should determine whether the assessment of fraud risks needs to be reassessed:
- 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^{1/}
 - (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
 - (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

^{1/} Paragraph 9 of Proposed Auditing Standard, *Audit Evidence*.

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- (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 sub-ledger and the control account, or between the customer statement and the accounts receivable sub-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:^{2/}

^{2/} 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*.)

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- 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 in permitting the auditor to meet privately with the audit committee
 - (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

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APPENDIX 6 – PROPOSED AUDITING STANDARD

October 21, 2008

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

Consideration of Materiality in Planning and Performing an Audit

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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. Financial reporting frameworks^{1/} discuss the concept of materiality in the context of the preparation and presentation of financial statements. For example, Financial Accounting Standards Board Statement of Financial Accounting Concepts ("FASB Concepts Statement") No. 2, *Qualitative Characteristics of Accounting Information*, states "The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item."^{2/}
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.

^{1/} 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.

^{2/} The formulation in the FASB Concepts Statement is similar to the formulation used by the courts in interpreting the federal securities laws. The Supreme Court 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.

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Note: When performing audit procedures, the auditor should be alert for misstatements that could be qualitatively material. Also, the auditor should evaluate uncorrected misstatements based on qualitative and quantitative factors. (See paragraph 18 of Proposed Auditing Standard, *Evaluating Audit Results*.) However, it ordinarily is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors.

Objective of the Auditor

4. 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

5. 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 surrounding circumstances.^{3/} 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, e.g., significant transactions or adjustments that are expected to be reflected in the financial statements at the end of the period.

6. Paragraph 20 of Auditing Standard No. 5 states, "In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she uses in the audit of the company's annual financial statements."

Materiality for Particular Accounts or Disclosures

7. The auditor should evaluate whether, in light of the surrounding circumstances, there are particular accounts or disclosures for which there is a substantial

^{3/} FASB Concepts Statement No. 2.

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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.

Determining Tolerable Misstatement

8. The auditor should determine the amount or amounts of tolerable misstatement^{4/} for purposes of assessing risks of material misstatement and planning and performing audit procedures. Tolerable misstatement should be established at an amount or amounts that reduces 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 as the Audit Progresses

10. The auditor should reassess the established materiality level or levels and tolerable misstatement if (1) 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 or (2) the financial statements used in establishing the materiality level or levels and in determining tolerable misstatement have changed significantly, e.g., because of significant adjustments to the financial statements.
11. 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.

^{4/} Paragraph .18 of AU sec. 350, *Audit Sampling*.

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Note: The reassessment of the materiality level or levels and tolerable misstatement is also relevant to the auditor's evaluation of identified misstatements in accordance with paragraph 18 of Proposed Auditing Standard, *Evaluating Audit Results*.

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APPENDIX 7 – PROPOSED AUDITING STANDARD

October 21, 2008

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

Audit Evidence

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Audit Evidence

Introduction

1. This standard 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 of the Auditor

3. The objective of the auditor is 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 plan and perform the audit 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.

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- *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. 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

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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.

Using Information Produced by the Company

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

Use of Assertions in Obtaining Audit Evidence

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.
 - *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.

^{1/} AU sec. 336, *Using the Work of a Specialist*, establishes requirements and provides direction for regarding using the work of a specialist employed or engaged by the company.

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- *Rights and obligations* – Assets are rights of the company, 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:
- a. In the audit of financial statements, the assertions are sufficient for the auditor to identify the types of potential misstatements and appropriately respond to the risks of material misstatement in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated, and
 - b. If the audit is an integrated audit of the financial statements and internal control over financial reporting, the auditor has selected and tested controls over the pertinent risks in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated.²

Audit Procedures for Obtaining Audit Evidence

13. The auditor should design and perform audit procedures to obtain sufficient appropriate audit evidence. Such audit procedures can be classified into the following categories:
- a. Risk assessment procedures^{3/} and
 - b. Further audit procedures,^{4/} which consist of:
 - (1) Test of controls and

^{2/} Paragraph 28 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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

^{4/} Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

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- (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 a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. 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 alone does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant

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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.

External Confirmation

18. An external confirmation represents audit evidence obtained by the auditor as a direct response to the auditor from a third party. Written confirmations might be received in paper form, or by electronic or other medium. External confirmation procedures frequently are used in relation to account balances and their constituent parts, e.g., confirmation of receivables by communication with debtors. However, external 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.

Reperformance

20. Reperformance 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.

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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 repetitive nature of a calculation or other process performed automatically by an information system makes a 100 percent examination cost effective.

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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 24-25 of this standard does not constitute audit sampling, and the results of those audit procedures cannot be projected to the entire population.

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 assess the effect if any, on other aspects of the audit.

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APPENDIX 8 – PROPOSED CONFORMING AMENDMENTS TO PCAOB STANDARDS

October 21, 2008

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

PROPOSED CONFORMING AMENDMENTS TO PCAOB STANDARDS

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Proposed Conforming 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 "appropriate."
- b. Footnote 2 to paragraph .04 is deleted.

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. Within footnote 3 to paragraph .06, the reference to AU sec. 311, *Planning and Supervision*, paragraph .07 is deleted.
- b. Within footnote 4 to paragraph .06, the phrase "See section 311.11" is replaced with, "See paragraph 19 of Proposed Auditing Standard, *Audit Planning and Supervision*."
- c. Footnote 6 to paragraph 11 is deleted.
- d. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

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- e. At the end of the fifth sentence of paragraph .12, the following parenthetical is added: "(See paragraph 8 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 reference to AU section 313, *Substantive Tests Prior to the Balance Sheet Date*, is deleted.
- b. In paragraph .02:
- The word "assistant" is replaced with "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 paragraphs .02 and .03, the references to AU section 313, *Substantive Tests Prior to the Balance Sheet Date*, are deleted.
- d. 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 3 of Proposed Auditing Standard, *Evaluating Audit Results*.

AU sec. 311, "Planning and Supervision"

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

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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 –

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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. Paragraph .01A is added –

.01A Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, establishes requirements and provides direction regarding identifying and assessing the risks of material misstatement, including risks of material misstatement due to fraud ("fraud risks"). Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, establishes requirements and provides direction regarding the auditor's overall responses and the audit procedures performed to respond to the risks of material misstatement, including fraud risks. Proposed Auditing Standard, *Evaluating Audit Results*, establishes requirements and provides direction regarding the evaluation of the results of the audit, including evaluating at the completion of the audit whether the accumulated results of auditing procedures and other observations affect the fraud risk assessment and whether identified misstatements may be indicative of fraud.

- 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:

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- Responses to fraud risks relating to fraudulent financial reporting and misappropriation of assets (see paragraph .53 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.
- In the second sentence of the ninth bullet point , "guidance" is replaced with "direction."
- f. Paragraph .03 is deleted.
- g. Footnote 6 to paragraph .08 is deleted.
- h. Paragraphs .14 through .45 are deleted, along with the preceding heading, "Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud".
- i. Footnotes 8 through 19, related to paragraphs .14 through .45 are deleted.
- j. Paragraphs .46 through .50 are deleted. The heading preceding paragraph .46 is replaced with the heading, "Responding to Fraud Risks."
- k. 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."
- l. Paragraph .52 is replaced with –

Paragraph 9 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, states that "the auditor should design and perform audit procedures the nature, timing, and extent of which address the fraud risks. The audit procedures that are necessary to address fraud risks depend upon the types of risks and the relevant assertions that might be affected."
- m. In paragraph .53:
 - The first sentence is replaced with –

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The following are examples of responses to 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 53 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*).
- The sixth bullet point is replaced with –
If other independent auditors are auditing the financial statements of one or more subsidiaries, divisions, or branches, discussing with them the extent of work that needs to be performed to address fraud risks resulting from transactions and activities among these components.

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

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

- o. 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 Fraud Risks Relating to Fraudulent Financial Reporting."

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

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

- q. 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 and provides

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direction 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 and provides direction to an auditor who uses the work of a specialist in performing an audit of financial statements."
- r. 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."
- s. 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 9 through 13 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."
- t. 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."
- u. 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.

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- v. Footnote 23 to paragraph .58 is replaced with –

See paragraphs 29 through 33 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.

- w. In paragraph .61:

- 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 testing of specific items.

- In the last sentence of the fifth bullet point, the reference to section 312.18, is replaced with paragraph 11 of Proposed Auditing Standard, *Audit Planning and Supervision*.

- x. In the third sentence of paragraph .63, the reference to section 312.36 is replaced with a reference to paragraphs 25 through 29 of Proposed Auditing Standard, *Evaluating Audit Results*.

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

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

- aa. 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 22 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.

- bb. The first sentence of paragraph .81 is replaced with –

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

cc. In paragraph .83:

- The reference in the first bullet point to paragraphs .14 through .17 is replaced with paragraphs 45 through 49 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*.
- The reference in the second bullet point to paragraphs .19 through .34 is replaced with paragraphs 37 through 44, paragraphs 50 through 55, and paragraphs 64 through 65 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 65 of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*), and the linkage of those risks to the auditor's response (see paragraphs 4 through 13 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.)

- The reference in the fourth bullet point to paragraph .41 is replaced with paragraph 61 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 13 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatements*.)

- The reference in sixth bullet point to paragraphs .68 through .73 is replaced with a reference to paragraphs 6 through 11 of Proposed Auditing Standard, *Evaluating Audit Results*.

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

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

This appendix contains examples of risk factors discussed in paragraphs 58 through 60 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 section 317, "Illegal Acts by Clients"), is amended as follows –

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

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 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

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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 44.
- 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 18 through 21.

AU sec. 324, "Service Organizations"

SAS No. 70, "Service Organizations" (AU 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*, paragraphs 34 through 35.
- 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.

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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. In the fourth sentence of paragraph .01, the word "competent" is replaced with "appropriate."
- b. In the first sentence of paragraph .03, the word "competent" is replaced with "appropriate."
- c. The third and fourth sentences of paragraph .03 are replaced with –

In selecting particular substantive tests to achieve the audit objectives he has developed, an auditor considers, among other things, the risk of material misstatement of the financial statements, including the assessed level of control risk, and the expected effectiveness and efficiency of such tests. His considerations include the nature and materiality of the items being tested, the kinds and competence of available evidential matter, and the nature of the audit objective to be achieved.

- d. The second sentence in paragraph .04 is replaced with –

Audit testing at interim dates may permit early consideration of significant matters affecting the year-end financial statements (e.g., related party transactions, changed conditions, recent accounting pronouncements, and financial statement items likely to require adjustment) and that much of the audit planning, including obtaining an understanding of internal control over financial reporting and assessing control risk, and the application of substantive tests to transactions can be conducted prior to the balance-sheet date. (See Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.)

- e. Footnote 1 to paragraph .04 is deleted.
- f. 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 37.
- g. In the first and second sentences of paragraph .10, the word "competent" is replaced with "appropriate."

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- h. The last two sentences of paragraph .12 are deleted.
- i. In the second sentence of paragraph .12, the word "competent" is replaced with "appropriate."
- j. In the first sentence of paragraph .13, the word "competent" is replaced with "appropriate."
- k. In paragraph .17, the word "competent" is replaced with "appropriate."
- l. In the second sentence of paragraph .21, the word "competent" is replaced with "appropriate."
- m. In the fourth sentence of paragraph .22, the word "competent" is replaced with "appropriate."
- n. In paragraph .23, the word "competent" is replaced with "appropriate."
- o. The reference in paragraph .24 to section 326, *Evidential Matter*, paragraph .03, is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*, paragraph 11.
- p. In the fourth sentence of paragraph .33, the word "competent" is replaced with "appropriate."

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 "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*

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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 "appropriate."
- e. In the second sentence of paragraph .32, the word "competent" is replaced with "appropriate."
- f. In the first sentence of paragraph .42, the word "competent" is replaced with "appropriate."
- g. In the second sentence of paragraph .44, the word "competent" is replaced with "appropriate."
- h. 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 14 through 19 and 25 through 29.

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 and provides direction on the use of substantive analytical procedures in an audit.

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

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Note: Proposed Auditing Standard, *Evaluating Audit Results*, establishes requirements and provides direction 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. 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 19 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.)
- g. Within footnote 1 to paragraph 9, 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 the second sentence of paragraph .21, the word "likely" is deleted.
- 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*.

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- b. The reference in paragraph .05 to section 312 is replaced with a reference to Proposed Auditing Standard, *Audit Risk in an Audit of Financial Statements*.
- 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.

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- 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 .20 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 25 through 29, provide directions on assessing bias in accounting estimates.
- h. In paragraph .43, subpart a., the word "competent" is replaced with the word "appropriate."
- i. 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 13.

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- 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 "appropriate".

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 in an Audit of Financial Statements*.

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 6, 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."

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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."

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- c. The reference in paragraph .08b.1. to section 311, *Planning and Supervision*, is replaced with Proposed Auditing Standard, *Audit Planning and Supervision*.
- d. Paragraph .14, is replaced with –

Proposed Auditing Standard, *Evaluating Audit Results*, paragraphs 25 through 29, discuss the auditor's responsibilities for assessing bias and evaluating accounting estimates in relationship to the financial statements taken as 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:

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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. In paragraph .07, the first sentence is replaced with –

Some degree of uncertainty is implicit in the concept of "a reasonable basis for an opinion," as described in paragraph 4 of Proposed Auditing Standard, *Audit Evidence*.

- f. Paragraph .08 is deleted.

- g. The reference in paragraph .09 to section 313 is deleted; the following note is added to paragraph .09 –

Note: Paragraphs 5 through 10 of Proposed Auditing Standard, *Audit Risk in an Audit of Financial Statements*, 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.

- h. The reference in paragraph .11 to section 311, *Planning and Supervision*, is replaced with a reference to Proposed Auditing Standard, *Audit Planning and Supervision*.

- i. The second sentence of paragraph .15, is replaced with –

For general direction regarding planning, refer to Proposed Auditing Standard, *Audit Planning and Supervision*.

- j. 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.)"

- k. 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

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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*.

Note: See paragraphs 8 through 9 of Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*, for direction regarding determining tolerable misstatement.

Note: 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 may be less than tolerable misstatement for the account balance or transaction class to allow for the possibility of misstatement in the portion of the account or class not subject to audit sampling.

- I. 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; 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

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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, particularly the assessment of the risk of material misstatement due to fraud, 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 12 through 24 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 47 through 49, of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, provides direction on performing procedures between the interim date of testing and period end.

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- 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 below 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: The note to paragraph 41 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, provides additional direction regarding 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 reference in item 6 of paragraph .48, to section 313 is deleted.
- z. Within footnote 1 to item 4 in paragraph .48, the sentence in the brackets is deleted, and the sentence referring to section 313, which is in parentheses, is deleted.

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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.

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") is amended as follows –

The reference in footnote 1 to paragraph .04 to 312.10, is replaced with Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*.

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 .20a., the word "competent" is replaced with the word "appropriate."
- b. In the second sentence of paragraph .22, the word "competent" is replaced with the word "appropriate."
- c. In the third sentence of paragraph .24, the word "competent" is replaced with the word "appropriate."
- d. 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*, paragraphs 25 through 29.

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- e. In the first sentence of paragraph .63, the word "competent" is replaced with the word "appropriate."

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

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

Footnote 4 to paragraph .16 is deleted.

AU sec. 623, "Special Reports"

SAS No. 62, "Special Reports" (AU sec. 623, "Special Reports"), as amended, is amended as follows –

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The reference in paragraph .24 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*.

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 12 through 24, 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. The last sentence of paragraph .16, is replaced with –

The accountant may find the direction in section 329, *Substantive Analytical Procedures*, useful in conducting a review of interim financial information.
- d. Footnote 20, to paragraph .26 is deleted.
- e. The reference in paragraph .56 to section 319 is replaced with a reference to section 316.

AU sec. 901, "Public Warehouse-Controls and Auditing Procedures for Goods Held"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 901, "Public Warehouses-Controls and Auditing Procedures for Goods Held" (AU sec. 901, "Public Warehouse-Controls and Auditing Procedures for Goods Held"), as amended, is amended as follows –

Within footnote 3 to paragraph .04, the reference to section 326 is replaced with a reference to Proposed Auditing Standard, *Audit Evidence*.

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Auditing Standard No. 3, *Audit Documentation*

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

The first sentence of paragraph A37, is replaced with –

Paragraph 29 of Proposed Auditing Standard, *Audit Evidence*, states: "If audit evidence obtained from one source is inconsistent with that obtained from another, or 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 assess the effect if any, on other aspects of the audit."

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 "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. 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*.

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- c. The reference in paragraph 15 to AU sec. 316.44 and .45 is replaced with a reference to Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, paragraphs 64 through 65.
- d. 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*.
- e. 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*.
- f. Within footnote 13 to the note to paragraph 31, the reference to AU sec. 312.39 is replaced with a reference to Proposed Auditing Standard, *Evaluating Auditing Results*, paragraphs 13 through 15. The reference to AU sec. 316.50 is replaced with a reference to Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, paragraph 4.
- g. 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*, Appendix A.
- h. In the first sentence of paragraph 51, the word "competent" is replaced with "appropriate."
- i. In the first sentence of paragraph 89, the word "competent" is replaced with "appropriate."
- j. Within the note to paragraph C6, the word "competent" is replaced with "appropriate."

Ethics Standards

ET sec. 102, "Integrity and Objectivity"

ET sec. 102, "Integrity and Objectivity," is amended as follows –

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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 Proposed Auditing Standards and Conforming Amendments

Proposed Auditing Standard – Audit Risk in an Audit of Financial Statements

1. Background

This proposed standard would establish requirements and provide direction regarding the auditor's consideration of audit risk in an audit of financial statements.

The proposed standard indicates 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 free of material misstatement due to error or fraud. It also states 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.^{1/}

The proposed standard describes audit risk in a financial statement audit. It also discusses the relationships among the various types of risk comprising audit risk. The Board believes that these audit risk concepts are fundamental to the auditing standards and should be retained in PCAOB auditing standards. The descriptions of the types of audit risk and their relationships are similar to the respective discussions in AU sec. 312, *Audit Risk and Materiality in Conducting an Audit* of the existing PCAOB standards.

Question

1. Does the proposed standard appropriately describe audit risk and its component risks?

^{1/} 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.

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Proposed Auditing Standard – Audit Planning and Supervision

1. Background

This proposed standard describes the auditor's responsibilities for planning an audit and supervising the work of engagement team members. It would supersede AU sec. 311, *Audit Planning and Supervision*.

The concept of audit planning has evolved since the Auditing Standards Board of the AICPA ("ASB") developed AU sec. 311, which contemplates that auditors will obtain an understanding of the company and its industry to plan the audit. With the increased use of risk-based audit methodologies, some auditors have devoted more attention to obtaining an understanding of the company and its environment, and the procedures performed to obtain this understanding are part of their risk assessment procedures. Many of the procedures that were formerly considered part of audit planning are now discussed in the proposed standard on identifying and assessing risks of material misstatement, as in the risk assessment standards of the International Audit and Assurance Standards Board ("IAASB"). The proposed standard on audit planning and supervision provides additional direction on planning matters such as developing an appropriate audit strategy and audit plan. In addition, it indicates that the engagement partner is responsible for planning the audit and supervising engagement team members. The proposed standard also indicates that the engagement partner may seek assistance from other engagement team members because, in many situations, particularly those involving larger or multi-location engagements, it is appropriate and necessary to do so.

2. Audit Planning

The proposed standard sets forth a principle for determining the necessary nature, timing, and extent of planning activities based on, e.g., the size and complexity of the company. The proposed standard then provides requirements and direction for the important aspects of planning, including performing preliminary engagement activities.

The audit strategy, also known as the audit approach, sets the scope, timing and direction of the audit. Although AU sec. 311 mentions audit strategy in the context of audit planning, the proposed standard provides more direction regarding the development of the audit strategy. The audit plan, which is referred to as an audit program in AU sec. 311, describes the planned audit procedures to be performed. The proposed standard retains the requirement in AU sec. 311.05 for a written audit plan.

Paragraph 7 of the proposed standard indicates that, as part of establishing the audit strategy and audit plan, the auditor should determine whether certain matters specified in the standard are important to the company's financial statements and

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internal control over financial reporting and, if so, how they will affect the auditor's procedures. This responsibility is an extension of a requirement in paragraph 9 of Auditing Standard No. 5.

Giving consideration to the matters listed in paragraph 7 of the proposed standard, some of which are in AU sec. 311, can lead auditors to develop more effective audit strategies and audit plans. For example, consideration of those matters can highlight areas that might warrant additional attention during the auditor's risk assessment procedures, which, in turn, could affect the audit procedures performed in response to the risks of material misstatement. Also, consideration of the internal control related matters can help the auditor develop an appropriate audit strategy, e.g., in determining accounts for which reliance on controls might be appropriate in the audit of the financial statements.

Paragraph 11 of the proposed standard sets forth requirements and direction regarding multi-location engagements, which have been retained from AU sec. 312.18. The requirements and direction, however, have been refined to align more closely with corresponding requirements and direction in Auditing Standard No. 5 for the audit of internal control over financial reporting. In particular, the proposed standard clarifies that the risk of material misstatement is a factor to consider in determining the locations for which testing needs to be performed.

The proposed standard also provides new direction regarding pre-engagement activities and initial audits that is similar to requirements in International Standard on Auditing ("ISA") 300, *Planning an Audit of Financial Statements*.

Individuals with Specialized Skill or Knowledge

The proposed standard includes requirements and direction regarding persons with specialized skill or knowledge. Generally, the requirements and direction have been retained from AU secs. 311.10 and 319.31-.32 of the interim standards.

The proposed standard indicates that the auditor should evaluate whether specialized skill or knowledge is needed to perform appropriate risk assessments, apply the planned audit procedures, or evaluate the results of the audit. This responsibility has been extended from a similar requirement in AU 311.10 regarding considering whether specialized information technology ("IT") skill or knowledge is needed on an audit. The Board believes that extending the requirement to individuals with specialized skill or knowledge in areas other than IT, such as forensic specialists, valuation specialists, and actuarial specialists is important because of the prevalent use of such individuals by auditors.

3. Supervision

In the supervision section of the proposed standard, the Board generally retained the requirements and direction regarding supervision from AU sec. 311, making

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changes as needed to conform to the terminology and requirements of the other proposed risk assessment standards.

Questions

2. Is it reasonable and appropriate to extend the Auditing Standard No. 5 requirement regarding consideration of matters important to the audit of internal control over financial reporting to audits of financial statements?
3. Is the direction regarding multi-location engagements reasonable and appropriate?
4. Is more direction needed regarding multi-location engagements? If so, in what areas is additional direction needed?
5. Are the responsibilities of the engagement partner for planning and supervision appropriate and reasonable, and is the proposed direction clear?

Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement

1. Background

This proposed standard describes the auditor's responsibilities for the process of identifying and assessing risks of material misstatement. This process includes (1) information-gathering procedures, known as "risk assessment procedures," and (2) evaluation of the information obtained in order to identify the risks of material misstatement and assess the significance of those risks.

In a risk-based audit, the auditor's testing of controls and testing of accounts and disclosures are directed toward the areas of greatest risk. The effectiveness of a risk-based audit, therefore, depends to a significant degree on whether the auditor identifies the risks of material misstatement and has an appropriate basis for assessing those risks. An effective risk assessment process is important in both the audit of internal control over financial reporting and the audit of financial statements.

Information from the Board's oversight activities has also indicated deficiencies in risk identification and assessment that led to inadequate or inappropriate audit

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procedures.^{2/} 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. Enhancing the direction in the auditing standards for identifying and assessing risks should lead auditors to improve their risk assessments and their ability to focus on areas of increased risk.

Under the proposed standard, the auditor's risk assessment procedures should be adequate to allow him or her to identify those risks that have a reasonable possibility of resulting in material misstatement of the financial statements and related disclosures and to have a reasonable basis for assessing the potential for material misstatement resulting from those risks.

2. Risk Assessment Procedures

The overarching principle related to risk assessment procedures is set forth in paragraph 5, which indicates that the auditor should perform risk assessment procedures to obtain sufficient appropriate evidence to identify and appropriately assess the risks of material misstatement due to error or fraud and to design further audit procedures.

The standard then sets forth requirements for performing risk assessment procedures, including obtaining an understanding of the company, its environment, and its internal control over financial reporting.

Obtaining an Understanding of the Company and Its Environment

AU sec. 311 of the interim standards describes the auditor's responsibilities for obtaining an understanding of the company and its environment. The proposed

^{2/} For example, PCAOB Release No. 2007-004, "Report on the Second-Year Implementation of Auditing Standard No. 2, *An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements*" (April 18, 2007), cited instances in which auditors assessed the level of risk only at the account level, which can lead to inadequate testing of higher risk assertions and excessive testing of lower risk assertions. Also, PCAOB Release No. 2007-010, "Report on the PCAOB'S 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms" (October 22, 2007), cited instances in which auditors failed to identify risk factors relating to potential impairments of assets and doubts about entities' ability to continue as a going concern.

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standard would expand the required understanding of the company and its environment to include certain additional matters, which are discussed in the following paragraphs.

Paragraph 13 sets forth additional procedures that the auditor should consider performing as part of obtaining an understanding of the company and its environment:

- 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
- Observing or reading transcripts of earnings calls
- Obtaining information about significant unusual developments regarding trading activity in the company's securities
- Obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements; changes or adjustments to those arrangements and special bonuses

Members of the Board's Standing Advisory Group suggested that these matters could provide valuable information for identifying risks of material 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 PAE Report recommended that auditors consider published analysts' reports and forecasts while gaining an understanding of the company's business and industry, assessing risks, and evaluating identified misstatements.^{3/} The Board believes that these procedures can provide important information on many audits, so the proposed standard establishes a responsibility to consider performing these procedures in each audit.

The proposed standard imposes a responsibility to evaluate how significant changes in the company from prior periods, including changes in its internal control, affect the risks of material misstatement. 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.^{4/} The proposed

^{3/} Public Oversight Board, Panel on Audit Effectiveness, Report and Recommendations ("PAE Report") (August 31, 2000), p. 58.

^{4/} AU sec. 319.38.

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standard requires the auditor to specifically evaluate the effect of such changes on the risks to the financial statements.

The proposed standard also 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.^{5/} The proposed standard provides examples of business risks that may result in a risk of material misstatement of the financial statements. However, the list of examples is meant to be illustrative rather than a checklist of factors to consider. Auditors would need to consider the business risks that are relevant to the particular company and industry. For example, in today's economic environment, business risks might include financing risks (e.g., access to necessary financing) or product risks (e.g., investments in certain financial products).

Also like the IAASB standards, the proposed standard would require the auditor to obtain an understanding of the company's performance measures that affect the risks of material misstatement. Understanding performance measures can help the auditor to identify accounts or disclosures that might be susceptible to manipulation to achieve targets for certain performance measures or to understand how management uses performance measures to monitor risks affecting the financial statements.

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.^{6/} The proposed standard, like the ISA, 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 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 accounting principles are more aggressive than those used in the relevant industry.

^{5/} PAE Report, p. 58.

^{6/} AU secs. 316 and 380.

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The proposed standards use the term used in the ISAs, "applicable financial reporting framework," rather than "generally accepted accounting principles." The Board believes the term used in the ISAs is appropriate for the audits of issuers. The proposed standard contains a footnote indicating that the auditor should look to the requirements of the U.S. Securities and Exchange Commission ("SEC") for the company under audit to determine the accounting principles applicable to that company. This formulation should focus the auditor on the accounting principles that may be used for purposes of the federal securities laws. This formulation is also consistent with an amendment to AU sec. 411 that was adopted by the Board when it adopted Auditing Standard No. 6.^{7/}

Obtaining an Understanding of Internal Control Over Financial Reporting

The proposed standard describes the auditor's responsibilities regarding obtaining an understanding of internal control over financial reporting. Although the auditor's primary focus is on internal control over financial reporting ("understanding of internal control"), the 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 formulation in the proposed standard is aligned more clearly with Auditing Standard No. 5.

Like the interim standard, the proposed standard sets forth certain principles regarding the sufficiency of the auditor's understanding of internal control over financial reporting. Under the proposed standard, the auditor has a responsibility 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 audit procedures. The proposed standard also indicates that the nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control over financial reporting depend on the size and complexity of the company; the auditor's strategy regarding testing controls; the auditor's existing knowledge of the company's internal control over financial reporting; 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 company's documentation of its internal control over financial reporting. For example, the auditor's procedures to obtain an understanding of internal control would be more extensive when the auditor's strategy involves more testing of controls (e.g., in an integrated audit), the company's internal control is more complex, or the company's controls have changed significantly.

^{7/} PCAOB Release No. 2008-001, Auditing Standard No. 6, *Evaluating Consistency of Financial Statements and Conforming Amendments* (January 29, 2008).

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Also like the interim standard, the proposed standard indicates that the understanding of internal control includes consideration of whether the controls are appropriately designed and implemented. In accordance with the principles discussed in the preceding paragraph, the amount of audit attention devoted to design and operating effectiveness will vary based on the auditor's strategy 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 because he or she will need to evaluate both the design and operating effectiveness of those controls.

To describe the auditor's responsibilities for obtaining an understanding of internal control, it was necessary to describe internal control over financial reporting in terms of its components. The components set forth in the proposed standard are similar to those used in the Board's interim standard, AU sec. 319, and in the respective standards of the IAASB. However, auditors may use other suitable recognized frameworks^{8/} in accordance with the direction in the standard. 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 the proposed standard to conform to the components in the framework used.

The interim standard requires the auditor to consider the collective effect on the control environment of strengths and weaknesses in the various control environment factors.^{9/} The proposed standard replaces that requirement with a new requirement to assess the following matters as part of obtaining an understanding of the control environment:

- 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.

This new requirement in the 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

^{8/} See Securities Exchange Act Release No. 34-47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

^{9/} AU sec. 319.35-.36.

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environment in an audit of financial statements only to be the same as that required when expressing an opinion on internal control over financial reporting. For audits of financial statements only, the 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.

The proposed standard would expand the auditor's responsibility for obtaining an understanding of the information system relevant to financial reporting. Under the proposed standard, like the ISAs, the auditor would be expected to obtain an understanding about relevant business processes relating to financial reporting. This was also a recommendation in the PAE Report.^{10/} The proposed standard provides additional direction to auditors in determining relevant business processes.

Also, the proposed standard expands the direction regarding understanding the period-end financial reporting process^{11/} 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 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 over financial reporting.

Considering Information from the Client Acceptance and Retention Evaluation and from Other Engagements

Paragraph .15b of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, indicates that a firm's quality control policies and procedures regarding client acceptance and retention should provide reasonable assurance that the firm "appropriately considers the risks associated with providing professional services in the particular circumstances." The matters that auditors consider when deciding whether to accept or retain a client or engagement may include information that is relevant to identifying risks of material misstatement, e.g., fraud risk factors or matters affecting the company's financial condition or operations. Similarly, the auditor might obtain information during audit planning that affects the risks of material misstatement. The proposed standard imposes a responsibility on auditors to

^{10/} PAE Report, p 15.

^{11/} 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.

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take into account relevant information obtained from the engagement acceptance or retention evaluation and audit planning activities in identifying the risks of material misstatement. Also, the proposed standard specifically states that risks of material misstatement identified during those activities should be included in the auditor's assessment of risks so the auditor can implement appropriate responses to those risks.

Another potential source of information about risks of misstatement is other engagements performed for the company. For example, if the auditor has performed a review of interim financial information in accordance with AU sec. 722, *Interim Financial Information*, the proposed standard states that the auditor should evaluate whether information obtained during the review is relevant to identifying risks of material misstatement in the year-end audit. The proposed standard also indicates that the auditor should assess whether information obtained in other engagements performed for the company is likely to be important for identifying risks of material misstatement. It also provides direction on how this requirement might be met in multi-location engagements.

Performing Analytical Procedures as Risk Assessment Procedures

The proposed standard retains the requirements and direction from AU sec. 329 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 proposed standard.

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

AU sec. 316 requires a discussion among engagement team members about risks of material misstatement due to fraud. The proposed standard, like the ISAs, extends this requirement to cover risks of material misstatement due to errors 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
- 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^{12/}

Through its inspections program, the Board has observed deficiencies relating to discussion among engagement team members regarding fraud risks.^{13/} 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 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 proposed standard also contains additional direction regarding multi-location engagements.

The changes to the requirements for engagement team discussions are not intended to substantially change the conduct of these engagement team discussions, except for the inclusion of risks of misstatement due to errors as well as fraud. Rather, the Board is seeking to promote more consistent performance in accordance with the standard.

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

^{12/} See paragraph A12 of ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*.

^{13/} 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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AU sec. 316 requires auditors to make inquiries of the audit committee, management and others regarding the risks of material misstatement due to fraud. The proposed standard incorporates those required inquiries and expands the inquiries to cover matters related to risks of material misstatement due to errors or fraud, which the ISA also does.

The proposed standard also specifically requires the auditor to make inquiries of accounting and financial reporting personnel, other than management, who are involved in initiating, authorizing, processing, or recording complex or unusual transactions. The purpose of these inquiries is to obtain the perspectives about risks of material misstatement, particularly fraud risks, from personnel who are directly involved with complex or unusual transactions, which can be more susceptible to misstatement than routine transactions.

Questions

6. Does the proposed standard clearly and adequately describe the auditor's responsibilities for performing risk assessment procedures?
7. Are the additional procedures in paragraph 13 that the auditor should consider performing when obtaining an understanding of the company and its environment reasonable and appropriate for audits of issuers? Should these procedures be specifically required for all audits, or is the responsibility to consider performing the procedures sufficient?
8. Is the new requirement to assess certain matters related to the control environment component of internal control over financial reporting reasonable and appropriate? Is the difference between the required performance for an audit of internal control over financial reporting and an audit of financial statements only clear?
9. Is the additional direction regarding the period-end reporting process reasonable and appropriate for audits of financial statements only?
10. Are the requirements and direction regarding the auditor's responsibilities for evaluating design and implementation of controls as part of obtaining an understanding of internal control over financial reporting sufficient and clear? If not, what additional direction is needed?
11. Does the additional description of the key engagement team members provide a better understanding of the expected participants in the discussion?

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3. Identification and Assessment of the Risks

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.^{14/} The process in the proposed standard is similar to the process for assessing fraud risks that is currently described in AU sec. 316 and the process described in the ISA.

The auditor's identification and assessment of the risks of misstatement provides the basis for identifying –

- Significant accounts and disclosures, and their relevant assertions
- Significant risks

Auditing Standard No. 5 requires the auditor to identify significant accounts and disclosures and their relevant assertions in integrated audits. Also, the 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.^{15/} The proposed standard imposes a more explicit requirement to identify significant accounts and disclosures and their relevant assertions.

The proposed standard, like the ISA, imposes 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.^{16/} This proposed standard provides a definition of the term "significant risk" and additional direction for identifying those risks.

The proposed standard carries forward the requirements from AU sec. 316 regarding the presumption that improper revenue recognition is a fraud risk. The proposed standard contains an additional requirement, like the related ISA, for the auditor to evaluate the types of revenue or revenue transactions to which the risk of

^{14/} The 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. Under the proposed standards, the auditor has a responsibility to perform risk assessment procedures that provide an appropriate basis for the risk assessments.

^{15/} A note to AU sec. 319.02 in the existing standards refers auditors to Auditing Standard No. 5 for direction on identifying relevant assertions.

^{16/} See, e.g., AU sec. 329.09.

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improper revenue recognition relates. This additional requirement should lead auditors to develop appropriate responses based on the nature of the fraud risk.

Question

12. Does the discussion of significant risks in this standard provide sufficient direction to enable auditors to identify significant risks?

4. Documentation

This proposed standard, and the other proposed standards, contain no specific documentation requirements. PCAOB Auditing Standard No. 3, *Audit Documentation*, establishes general requirements for documentation that the auditor should prepare and retain in connection with engagements performed pursuant to the standards of the PCAOB. Paragraph 5a of Auditing Standard No. 3 indicates that the audit documentation should demonstrate that the engagement complied with the standards of the PCAOB. Paragraph 5b of Auditing Standard No. 3 indicates that the audit documentation should support the basis for the auditor's conclusions regarding every relevant financial statement assertion. Paragraph 6 of Auditing Standard No. 3 indicates that the auditor must document the procedures performed, evidence obtained, and conclusions reached regarding relevant financial statement assertions.

The Board believes that Auditing Standard No. 3 imposes sufficient responsibilities on auditors to prepare the necessary documentation in relation to the procedures and other matters covered by the proposed risk assessment standards. For example, in accordance with Auditing Standard No. 3, the auditor's documentation should include documentation of –

- Risk assessment procedures
- A summary of the identified risks and the auditor's assessment of risks at the financial statement and assertion levels and the risks that are determined to be significant risks
- The auditor's responses to the risks of material misstatement, including a summary of the linkage of the assessed risks to the auditor's responses
- A summary of accumulated misstatements and evaluation of uncorrected misstatements

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- The auditor's conclusions regarding the financial statements and whether the auditor has obtained sufficient appropriate evidence to support his or her opinion on the financial statements.

Accordingly, the Board believes that it is not necessary to prescribe specific documentation requirements.

Question

13. Should the proposed standards include specific requirements and direction regarding documentation, e.g., summaries of the identified and assessed risks and the linkage to the auditor's responses?

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

1. Background

The proposed standard describes the auditor's responsibilities for responding to the risks of material misstatement, including fraud risks, which should be identified in accordance with the proposed standard on identifying and assessing risks of material misstatement.

The PAE Report and PCAOB inspections reports,^{17/} among other sources, have cited instances in which the auditors did not perform audit procedures that addressed the risks of material misstatement that they had identified. In developing this standard, the Board seeks to establish requirements and provide direction that will improve auditors' performance in tailoring their audit procedures to address the risks of material misstatement.

2. Types of Responses to the Risks of Material Misstatement

This standard would require the auditor to respond to the risks of material misstatement in two ways –

- Responses that have an overall effect on how the audit is conducted

^{17/} See PCAOB Release 2007-001, "Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud" (January 22, 2007), which states that inspectors had observed instances in which auditors had failed to perform procedures to address identified fraud risks.

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- Responses involving the nature, timing, and extent of the audit procedures to be performed.

Both types of responses are required on all audits. The proposed standard also establishes requirements and provides direction for each type of response.

3. Overall Responses

The proposed standard indicates that the auditor should design and implement overall responses to address the risks of material misstatement in the following areas:

- Making appropriate assignments of significant engagement responsibilities
- Providing an appropriate level of supervision and review of the work of engagement team members
- Incorporating elements of unpredictability in the selection of audit procedures to be performed
- Evaluating the company's selection and application of significant accounting principles
- Making general changes to the nature, timing, or extent of audit procedures

Such responses were required by AU sec. 316 in response to fraud risks, but the proposed standard would expand the requirement to apply to risks of material misstatement due to errors or fraud. The nature of these responses is such that they are appropriate for every audit and may be appropriate for addressing risks of material misstatement due to errors or fraud.

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

The proposed standard states that auditors should design and perform audit procedures the nature, timing, and extent of which are based on and address the risks of material misstatement for each relevant assertion of each significant account and disclosure.

The proposed standard sets forth three principles that the auditor should follow when designing the audit procedures to respond to the risks of material misstatement. These principles indicate that the auditor's procedures should be –

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- Calibrated to the level of risk
- Tailored to the types of potential misstatements and consistent with the auditor's risk assessments
- In integrated audits, designed to address the objectives of both the audit of internal control over financial reporting and the audit of the financial statements

The auditor's responsibilities in paragraphs 6, 7a, and 7b of the proposed standard, regarding designing and performing audit procedures that address the risks of material misstatement, are consistent with the principles set forth in AU sec. 312, AU sec. 319, and AU sec. 316. However, the responsibilities as described in the proposed standard are intended to lead auditors to design audit procedures that address more directly the risks of material misstatement identified in their risk assessments.

The audit procedures discussed in this proposed standard include tests of controls and substantive procedures.

Tests of Controls

In all integrated audits, and in many audits of financial statements only, the auditor's response to the risks of material misstatements includes tests of controls. Therefore, this proposed standard includes requirements and direction regarding tests of controls.

Currently, the requirements and direction regarding tests of controls are contained in two separate PCAOB auditing standards. Auditing Standard No. 5 describes the auditor's responsibilities regarding tests of controls in the audit of internal control over financial reporting,^{18/} and AU sec. 319 describes the auditor's responsibilities regarding tests of controls in an audit of financial statements.

The proposed standard establishes requirements and provides direction for tests of controls that applies to audits of financial statements only and to integrated audits, in particular, to the financial statement audit portion of the integrated audit. The proposed standard does not change the existing requirements and direction in Auditing Standard No. 5; rather, it articulates the requirements and direction on tests of controls in a manner that aligns more closely with Auditing Standard No. 5. This is intended to, among other things, help auditors design their tests to accomplish the objectives of both

^{18/} Paragraphs B1-B9 of Auditing Standard No. 5 also discuss the integration of the testing of controls in the audit of internal control over financial with testing of controls in the audit of financial statements.

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the audit of the financial statements and the audit of internal control over financial reporting.

The requirements and direction regarding tests of controls in the proposed standard was developed primarily from the corresponding direction from Auditing Standard No. 5. In the Board's view, the basic principles for designing and performing tests of controls are the same for the audit of internal control over financial reporting and the audit of the financial statements. The primary differences relate to the objectives of the testing, the principles for selecting controls to test, the timing of testing, and the amount of evidence needed from the tests. Paragraphs 14-16 of the proposed standard discuss the objective of tests of controls in the audit of internal control over financial reporting and the key principles for selecting controls to test and determining the evidence needed regarding control effectiveness. Paragraphs 17-20 discuss the objective of tests of controls in the audit of financial statements and the key principles for selecting controls to test and determining the evidence needed regarding control effectiveness. Paragraphs 21-22 discuss testing the design and operating effectiveness of controls, and those paragraphs apply to both the audit of internal control over financial reporting and the audit of financial statements, except where indicated otherwise. Paragraphs 38-39 then establish requirements and provide direction regarding assessing control risk in the audit of financial statements. For an audit of financial statements only, the auditor would follow the requirements and direction in Paragraphs 17-39 except for those requirements that are identified as applying only to the audit of internal control.

This proposed standard and Auditing Standard No. 5 indicate that, when the auditor relies on controls in the audit of the financial statements, he or she should test controls over the period of reliance. Footnote 13 of the proposed standard defines the term "period of reliance" as "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."

Questions

14. Does the proposed standard clearly describe the auditor's responsibilities regarding tests of controls in integrated audits and in audits of financial statements only?
15. Are the requirements and direction regarding tests of controls appropriately aligned with Auditing Standard No. 5?

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Substantive Procedures

The proposed standard would retain the requirement in existing PCAOB standards^{19/} that auditors perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.

The proposed standard sets forth principles for determining the appropriate nature, timing, and extent of substantive procedures. Although these principles are consistent with the existing PCAOB standards, the proposed standard provides additional direction that is intended to lead auditors design audit procedures that are based on and that address the risks of material misstatement.

For significant risks, the proposed standard on the auditor's response would require the auditor to perform substantive procedures that are specifically responsive to the risks. Existing PCAOB standards^{20/} indicate that it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient responses to significant risks. Consistent with these principles, the proposed standard indicates that the substantive procedures that address significant risks should include tests of details.

The proposed standard carries forward the basic principles in AU sec. 313 regarding performing substantive procedures as of an interim date and the intervening period through year-end. However, the formulation of these requirements has been revised to align more closely with the risk-based principles in the remainder of this standard.

Question

16. Does the proposed standard clearly describe the auditor's responsibilities regarding substantive procedures?

Responses to Fraud Risks

In existing PCAOB standards, AU sec. 316 describes the auditor's responsibilities for responding to fraud risks in the audit of financial statements. Those responses include certain overall responses and certain specific responses involving the nature, timing, and extent of audit procedures. The proposed standard carries forward the key principles from AU sec. 316 for responding to fraud risks. For example, the proposed standard includes the same overall responses as AU sec. 316, although it

^{19/} AU sec. 319.02.

^{20/} AU sec. 329.09.

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broadens certain of those requirements to apply to risks of material misstatement due to errors or fraud. Under the proposed standard, the general principles for responses involving audit procedures also apply to responses to fraud risks. In addition, the proposed standard states that the auditor should perform procedures, including tests of details, that are specifically responsive to the fraud risks. This requirement is drawn from the requirements for responding to significant risks because the proposed standard on identifying and assessing risks of material misstatement indicates that fraud risks are significant risks. This statement is also consistent with the principle in the AU sec. 329.10 that substantive analytical procedures alone are not well suited to detecting fraud. The remaining direction regarding responding to fraud risks carries forward key principles from AU sec. 316 and references AU sec. 316 for further direction regarding those responses.

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 in order to form the opinion(s) to be presented in the auditor's report. The proposed standard would consolidate into one standard the requirements and direction that currently are included in five separate auditing standards^{21/} to better highlight matters that are important to the auditor's conclusions about the financial statements and the effectiveness of internal control over financial reporting.

2. Evaluating the Results of the Audit of Financial Statements

Under the proposed standard, the auditor's evaluation of the audit results would encompass the following:

- The results of analytical procedures in the overall review of the financial statements,
- Identified misstatements,

^{21/} AU sec. 312, regarding evaluating audit results, including uncorrected misstatements; AU sec. 316, regarding fraud considerations that are relevant to evaluating audit results; AU sec. 329, regarding performing the overall review; AU sec. 319 regarding the relationship of audit evidence obtained on control risk assessments; and Auditing Standard No. 5, regarding the evaluating the results of the audit of internal control and the effect of the results of the audit of internal control on the financial statement audit.

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

3. Performing Analytical Procedures in the Overall Review

The proposed standard retains the requirements in AU secs. 316 and 329 to read the financial statements and disclosures and perform analytical procedures in the overall review. The conclusions formed from the results of the overall review of the audit are intended to corroborate conclusions formed during the audit of individual accounts and disclosures.

While performing the overall review, the auditor might discover unusual or unexpected transactions, events, or amounts or analytical relationships that indicate risks of material misstatements that were not identified previously and for which the audit procedures need to be modified or additional procedures need to be performed. Some unusual or unexpected analytical relationships might have been identified and might indicate a fraud risk because management or employees generally are unable to manipulate certain information to create seemingly normal or unexpected relationships, such as the following:

- The relationship of net income to cash flows from operations might appear unusual because management recorded fictitious revenues and receivables but was unable to manipulate cash.
- Changes in inventory, accounts payable, sales, or cost of sales from the prior period to the current period may be inconsistent, indicating a possible employee theft of inventory, because the employee was unable to manipulate all of the related accounts.
- A comparison of the entity's profitability to industry trends, which management cannot manipulate, may indicate trends or differences for further consideration when identifying risks of material misstatements due to fraud.
- A comparison of bad debt write-offs to comparable industry data, which employees cannot manipulate, might provide unexplained relationships that could indicate a possible theft of cash receipts.

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- An unexpected or unexplained relationship between sales volume as determined from the accounting records and production statistics maintained by operations personnel, which might be more difficult for management to manipulate, might indicate a possible misstatement of sales.

The proposed standard also requires 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.

4. Accumulating and Evaluating Identified Misstatements

Accumulating Identified Misstatements

The proposed standard indicates that the auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial.^{22/} The threshold for misstatements that are clearly trivial should be set so that any misstatements below that amount are not material to the financial statements, individually or in combination with other misstatements, considering the possibility of undetected misstatements. Accordingly, the threshold for clearly trivial amounts should be substantially less than tolerable misstatement or the materiality levels established for planning and performing the audit.

AU sec. 312.34 classifies misstatements into two categories – known (misstatements specifically identified during the audit) and likely (the auditor's best estimate of misstatements in an assertion), and states that auditors should accumulate likely misstatements. The proposed standard retains the principle that the auditor should accumulate his or her best estimate of the misstatement in the accounts that he or she has tested without using the terms "known misstatement" and "likely misstatement." Instead, the proposed standard indicates that the auditor should consider distinguishing the misstatements among specifically identified misstatements, projected misstatements from substantive audit sampling and misstatements related to accounting estimates. Distinguishing the types of misstatements can be useful for evaluating the uncorrected misstatements or for communicating the misstatements to the audit committee. For example, a projected misstatement from an audit sampling method provides an indication of the amount of potential misstatement in the sample population, but additional examination might be necessary to determine the necessary corrections to the financial statements. Also, misstatements related to accounting estimates might be useful when evaluating the potential for bias in other accounting estimates.

^{22/} The proposed standard uses the term "clearly trivial," the term used in the IAASB standard, rather than "clearly inconsequential," the term used in the interim standards. The meaning of the two terms is the same.

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Evaluating the Effect of Uncorrected Misstatements

The proposed standard indicates 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.^{23/}

Prior Period Misstatements

The proposed standard states that the auditor should evaluate the effect of prior period uncorrected misstatements on the current period financial statements. Like the existing standard, the proposed standard does not address how to evaluate the effect of prior period misstatements because that is an accounting and financial reporting matter.^{24/}

Fraud Risk Considerations

The proposed standard requires the auditor to evaluate whether identified misstatements might indicate fraud. It also includes a new requirement from the ISAs to evaluate circumstances or conditions, which might indicate collusion involving employees, management or external parties when evaluating the reliability of audit evidence.

5. Evaluating the Qualitative Aspects of the Company's Accounting Practices

The proposed standard requires the auditor to evaluate the qualitative aspects of company's accounting practices, including the possibility of management bias in matters such as:

- Selective correction of misstatements
- Selection and application of accounting principles
- Development of accounting estimates

The proposed standard also describes the auditor's responsibilities in situations in which bias exists. AU sec. 316 provides direction on specific aspects of evaluating bias of accounting estimates and selection and application of accounting principles, but

^{23/} The SEC staff has provided guidance in Staff Accounting Bulletin No. 99 on the effects of qualitative factors on the evaluation of uncorrected misstatements.

^{24/} For example, the SEC staff has provided guidance in Staff Accounting Bulletin No. 108 on the effects of prior year misstatements when quantifying misstatements in the current year financial statements.

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this requirement in the proposed standard imposes a broader responsibility to evaluate the potential effect of management bias on the financial statements. The ISAs have similar requirements.

6. Evaluating Conditions That Relate to the Assessment of Fraud Risks

Appendix A of the proposed standard describes certain conditions that might affect the assessment of fraud risks if identified during the audit. Most of the conditions are carried forward from AU sec. 316, but the list of conditions has been expanded to include the following items from the ISA that also warrant consideration by the auditor:

- Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships – for example, receivables growing faster than revenues
- Large numbers of credit entries and other adjustments made to accounts receivable records
- Unexplained or inadequately explained differences between the accounts receivable sub-ledger and the control account, or between the customer statement and the accounts receivable sub-ledger
- Missing or non-existent cancelled checks in circumstances in which cancelled checks are ordinarily returned to the company with the bank statement
- Fewer responses to confirmation requests than anticipated or a greater number of responses than anticipated
- An unwillingness to appropriately address significant deficiencies in internal control on a timely basis
- Unwillingness by management to permit the auditor to meet privately with the audit committee
- Accounting policies that appear inconsistent with industry practices that are widely recognized and prevalent
- Frequent changes in accounting estimates that do not appear to result from changing circumstances
- Tolerating violations of the company's code of conduct

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The auditor's identification of one or more conditions presented in Appendix A does not necessarily mean that fraud exists. However, the auditor has a responsibility to determine whether the conditions that are identified during the audit affect the assessment of fraud risks. The Board seeks comment on whether the list of conditions in Appendix A and the accompanying direction are reasonable and appropriate, and, in particular, whether there are conditions in Appendix A that should be added, removed, or modified.

7. Evaluating the Sufficiency and Appropriateness of Audit Evidence

PCAOB standards require the auditor to obtain sufficient competent evidence to obtain reasonable assurance in order to express the opinion(s) in the audit report, and the standard auditor's report includes a representation about the sufficiency of the auditor's work. The proposed standard specifically requires the auditor to evaluate whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements, and the standard provides direction on the matters to be considered during this evaluation.

8. Evaluating the Results of an Integrated Audit

The proposed standard describes the auditor's responsibilities for evaluating audit results in an integrated audit as well as in an audit of financial statements only. Specifically, the standard addresses how, in integrated audits, the evaluation of the results of the audit of internal control affects the auditor's conclusions in the audit of the financial statements and vice versa. It also summarizes key principles of the evaluation of audit results in the audit of internal control, in which case the proposed standard references, but does not repeat, the relevant requirements and direction from Auditing Standard No. 5 regarding evaluating the severity of control deficiencies.

Questions

17. Does the proposed standard clearly describe the auditor's responsibilities regarding the evaluation of audit results?
18. Are the requirements and direction regarding the accumulating identified misstatements and evaluating uncorrected misstatements appropriate and adequate?
19. Are the requirements and direction regarding the evaluation of the results of the integrated audit appropriately aligned with Auditing Standard No. 5?

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

1. Background

This proposed standard describes the auditor's responsibilities regarding the consideration of materiality in planning and performing an audit.^{25/}

The concept of materiality is articulated in the federal courts' interpretations of the federal securities laws. In developing this proposed standard, the Board sought to describe the auditor's responsibilities for appropriately applying the concept of materiality in planning and performing audit procedures.

The requirements and direction in the existing PCAOB standards regarding the auditor's consideration of materiality is set forth primarily in AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*. The auditor's responsibilities under the proposed standard are fundamentally the same as in the interim AU sec 312. However, the proposed standard contains some additional direction, as described in the following paragraphs.

2. Applying the Concept of Materiality in Planning and Performing the Audit

The auditor's responsibilities for applying the concept of materiality as described in this standard are based on the principle that, 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, would result in material misstatement of the financial statements.

The proposed standard establishes responsibilities for the auditor to –

1. establish an appropriate materiality level for the financial statements as a whole
2. establish a lower materiality level or levels for particular accounts or disclosures when necessary
3. determine an amount or amounts of "tolerable misstatement," which are lower than the preceding amounts and which are used for determining the scope of audit procedures

^{25/} This standard is closely related to the proposed standard on evaluating audit results, which, among other things, establishes requirements and provides direction on the auditor's consideration of materiality in evaluating uncorrected misstatements identified during the audit.

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AU secs. 312.14 and 312.19, in effect, establish a responsibility for the auditor to "make a preliminary judgment" about materiality when planning the audit. The proposed standard indicates 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 surrounding circumstances.^{26/} 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 a nominal net income or loss.

AU sec. 312.14 indicates that the auditor's preliminary judgment about materiality need not be quantified. As a practical matter, many of the auditor's decisions involving planning the scope of the audit are quantitative, e.g., decisions about the extent of audit procedures. Accordingly, the proposed standard includes a statement that, in planning the audit, the auditor's materiality level for the financial statements as a whole needs to be expressed as a specified amount.

AU sec. 312.20 discusses the consideration of qualitative factors affecting materiality in planning and performing an audit. The proposed standard includes similar direction. The proposed standard indicates that the auditor should be alert for misstatements that could be qualitatively material and should evaluate uncorrected misstatements based on qualitative factors, but that ordinarily it is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors. This statement acknowledges that, as a practical matter, the auditor typically obtains information about qualitative factors affecting materiality through the procedures performed during the audit, e.g., information about the nature and cause of misstatements identified during the audit.

AU sec. 312.19 discusses establishing an overall materiality level based on the smallest aggregate level of misstatement that would be considered material to any of the individual financial statements. The proposed standard establishes a responsibility for the auditor to consider whether, for particular accounts or disclosures, misstatements in amounts less than the materiality level for the financial statements as a whole could influence the judgment of a reasonable investor. In those circumstances,

^{26/} See, e.g., Financial Accounting Standards Board Statement of Financial Accounting Concepts ("FASB Concepts Statement") No. 2, *Qualitative Characteristics of Accounting Information*. The Financial Accounting Standards Board has proposed a new Statement of Financial Accounting Concepts that would supersede FASB Concepts Statement No. 2. The Board will consider the status of the relevant FASB Concepts Statement in future deliberations of this proposed auditing standard.

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the auditor is required to establish separate materiality levels for such accounts or disclosures. The formulation in the proposed standard is more consistent with the principle of considering the perceptions of investors when making 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 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.

AU sec. 312.25 provides direction on applying auditor judgments about materiality to the determination of the scope of the audit procedures at the account level. In the proposed standard, this is addressed through the direction regarding tolerable misstatement.

To relate the auditor's materiality judgments to individual accounts and disclosures, the proposed standard indicates that the auditor should determine the amount or amounts of tolerable misstatement for purposes of assessing risks and planning and performing audit procedures. Tolerable misstatement is less than the materiality levels discussed in the preceding paragraphs because tolerable misstatement takes into account the amount of expected misstatement in the accounts as well as the amount of the possible undetected misstatement. The expectations about misstatement in the accounts and disclosures should be informed by the auditor's risk assessment procedures and other relevant information about the company and the respective accounts and disclosures, including the nature, cause and amount of misstatements identified in audits of prior periods.

Questions

20. Are the requirements and direction in this standard appropriately aligned with the concept of materiality as described in the courts' interpretation of the federal securities laws?

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21. Does the proposed standard sufficiently and clearly describe the auditor's responsibilities regarding (a) establishing an appropriate materiality level for the financial statements as a whole and (b) establishing a lower materiality level or levels for particular accounts or disclosures? If not, what additional direction is needed?
22. Is the use of the term "tolerable misstatement" in the proposed standard appropriate and sufficiently clear?

Proposed Auditing Standard – Audit Evidence

1. Background

This proposed standard would establish requirements and provide direction regarding the use of audit evidence and designing and performing audit procedures to obtain sufficient appropriate audit evidence.

The proposed standard would supersede AU sec. 326, *Audit Evidence*. The most significant differences between the proposed standard and AU sec. 326 relate to –

- Terminology
- Enhancements to the direction regarding relevance and reliability of audit evidence
- Additional direction regarding specific audit procedures
- Additional direction regarding selection of items for testing

2. Sufficient Appropriate Audit Evidence

The proposed standard explains the meaning of "sufficient" and "appropriate" as used in the phrase "sufficient appropriate audit evidence." The 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.

AU sec. 326 refers to obtaining sufficient competent audit evidence. The proposed risk assessment standards use the word "appropriate" rather than "competent" to follow the terminology in the ISA. The proposed standard describes the term "appropriate" as evidence that is both "relevant" and "reliable." The proposed standard also provides direction to auditors on determining the relevance and reliability

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of audit evidence. AU sec. 326 provides no direction on assessing the relevance of audit evidence. The proposed standard's discussion regarding reliability covers two additional matters that are not addressed in AU sec. 326:

- The use of original documents rather than photocopies, facsimiles or electronic versions of documents.
- A responsibility regarding considering the reliability of documents and performing additional procedures if conditions indicate that a document might not be authentic or might have been altered. This is a more direct description of the auditor's responsibilities than the interim standards.

Questions

23. Does the proposed standard clearly describe the principles necessary for evaluating the sufficiency, relevance, and reliability of audit evidence?
24. Are the auditor's responsibilities regarding the authentication of documents reasonable and appropriate?
25. Are the requirements and direction related to selecting items for testing appropriate and clear?

3. Use of Assertions in Obtaining Audit Evidence

Financial statement assertions are an important consideration for audits performed in accordance with PCAOB standards. For example, both existing PCAOB standards and the proposed risk assessment standards require auditors to:

- Perform substantive procedures for the relevant assertions of the significant accounts and disclosures in audits of financial statements; and
- Obtain evidence about the design and operating effectiveness of selected controls over relevant assertions of significant accounts and disclosures in audits of internal control over financial reporting.

This proposed standard explains what financial statement assertions are and describes five categories of financial statement assertions, which is consistent with AU sec. 326 and Auditing Standard No. 5. The proposed standard allows auditors to use categories of assertions that differ from the assertions listed in this standard under certain specified conditions. The requirements and direction regarding financial

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statement assertions in this proposed standard are consistent with the requirements in existing PCAOB standards.

Question

26. Are the five categories of assertions in this standard sufficient or should they be expanded? If so, how would such expansion affect auditor performance?

4. Direction Regarding Types of Audit Procedures

The proposed standard provides more details about the purpose and nature of specific types of audit procedures than is provided in AU sec. 326. Although this additional discussion is new to the evidence standard, it is consistent with respective discussion in other PCAOB standards. Presenting this additional information in the evidence standard can help auditors in determining the nature of their audit procedures.

5. Selecting Items for Testing

The proposed standard contains a section on selecting items for testing. Currently, this topic is covered in an auditing interpretation to AU sec. 350, *Audit Sampling*.^{27/} The interpretation discusses the subject in the context of audit procedures that do not involve audit sampling, while the proposed standard establishes an overall principle for selecting items for testing and discusses the use of the alternative selection methods.

6. Other Changes

Certain topics that appear in AU sec. 326 are omitted from the proposed standard. AU sec. 326 discusses the use of audit objectives, and an appendix to that standard illustrates how auditors might use assertions to develop audit objectives and substantive tests of inventory. Such a discussion is not necessary because the auditing standards do not require auditors to establish audit objectives to link assertions to substantive procedures. However, omission of this direction would not preclude auditors from using audit objectives in designing their audit procedures.

^{27/} AU sec. 9350, *Audit Sampling: Auditing Interpretations of AU sec. 350*.

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Section-by-Section Description of Proposed Conforming Amendments to PCAOB Auditing Standards

The following section of this appendix discusses the nature of the proposed conforming amendments to PCAOB standards.

Proposed Conforming Amendments to Auditing Standard No. 3

Paragraph A37 of Auditing Standard No. 3 contains a quote from AU sec. 326.25, which would be replaced with a similar quote from the proposed standard on evaluating audit results.

Proposed Conforming Amendments to Auditing Standard Nos. 4 and 5

The proposed conforming amendments to Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, and Auditing Standard No. 5 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.

Proposed Conforming Amendments to Interim Auditing Standards

Superseded Sections

The proposed auditing 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*

Similarly, the auditing interpretations of AU secs. 311, 312, and 350 have been incorporated into the proposed auditing standards and thus would be superseded.

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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 proposed risk assessment 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 - .51; and evaluating audit results, principally, AU secs. 316.68-.78; have been incorporated into the proposed risk assessment 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 provide an overview of the auditor's consideration of fraud and, where applicable, references to the appropriate requirements and direction in the proposed standards.

AU sec. 329, Analytical Procedures

The discussion in this interim standard 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. Inspections teams have observed instances in which auditors performed substantive procedures to test accounts without meeting the requirements in AU sec. 329 for substantive analytical procedures.^{28/}

^{28/} 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. 350, Audit Sampling

The discussion in AU sec. 350 regarding audit risk and tolerable misstatement have been amended to align more closely with the proposed standards. In particular, AU secs. 350.23 and 350.38 have been amended to explain more specifically how the principles in the standard for determining sample sizes when nonstatistical sampling approaches are used.

Other Conforming Amendments to the Interim Auditing Standards

For the following interim auditing standards, the proposed amendments are limited to changing the word "competent" to "appropriate," when that word is used in reference to audit evidence, and/ or 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*
- 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*

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- 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 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 9342, *Auditing Accounting Estimates : Auditing Interpretation of 342*
- AU sec. 411, *The Meaning of Presented Fairly in Conformity with Generally Accepted Accounting Principles*
- 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*
- AU sec. 901, *Public Warehouses – Controls and Auditing Procedures for Goods Held*

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 was superseded.

Proposed Conforming Amendments to Interim Ethics Standards

In the interim ethics standard, ET sec. 102, *Integrity and Objectivity*, the proposed conforming amendments are limited to updating references to auditing standards that are being superseded or amended.

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APPENDIX 10

Comparison of Requirements to the Standards of the International Auditing and Assurance Standards Board^{1/}

The proposing release discusses the Board's approach to considering the International Standards on Auditing ("ISAs") of the International Auditing and Assurance Standards Board ("IAASB") in developing the proposed standards. The following paragraphs discuss significant differences between the requirements of the proposed PCAOB standards and the requirements of the respective ISAs.

Proposed Auditing Standard – Audit Risk in an Audit of Financial Statements

The provisions of this standard are similar to the discussion of audit risk included in ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

Proposed Auditing Standard – Audit Planning and Supervision

The respective IAASB standard for audit planning is ISA 300, *Audit Planning*.

The responsibility in paragraph 7 of the proposed standard to consider the importance of certain matters and how they affect the audit strategy and audit plan is unique to PCAOB standards.

The proposed standard carries forward the requirements and direction in AU sec. 312.18 regarding multi-location engagements, with a few changes to align it more closely with the related direction in Auditing Standard No. 5. The IAASB's primary direction regarding multi-location engagements is set forth in ISA 600 on group audits. Providing direction on group audits is beyond the scope of these proposed standards.

As discussed in Appendix 9, the proposed standard retains, without significant re-evaluation, the requirements regarding supervision from AU sec. 311 of the interim standards. Accordingly, a detailed comparison of existing PCAOB requirements for supervision with those of the ISAs was not necessary.

^{1/} The Board understands that the Auditing Standards Board is in the process of updating its risk assessment standards as part of their clarity project. Therefore, this appendix compares the proposed standards only to the standards of the IAASB.

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Proposed Auditing Standard – Identifying and Assessing Risks of Material Misstatement

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*, are the respective IAASB's auditing standards regarding identifying and assessing the risks of material misstatement. The following paragraphs discuss differences between the requirements in the proposed standard and those in ISA 315 and ISA 240 where applicable.

The proposed standard is applicable to both the audit of internal control over financial reporting and the audit of the financial statements. Paragraph 7 of the proposed standard indicates that the auditor's risk assessment procedures should apply to both audits. ISA 315 applies only to audits of financial statements and, accordingly, there is no such requirement. Consequently, the requirements that are specific to audits of internal control, such as that in paragraph 24 of the proposed standard, are unique to the proposed standard.

The requirement in the proposed standard to obtain an understanding of how changes in the company from prior periods affect risks of material misstatements is presented in ISA 315 as application material rather than a requirement in the ISA.

Paragraph 13 of the proposed standard presents a list of additional audit procedures that the auditor should consider performing while obtaining an understanding of the company and its environment. ISA 315 has no such requirement, although the ISA 315 application material cites reviewing information obtained from external sources, such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications as a procedure that might be helpful in identifying risks of material misstatement.

Both the proposed standard and ISA 315 require auditors to obtain an understanding of the company's selection and application of accounting principles. The proposed standard includes a list of matters that the auditor should understand in relation to the company's selection and application of accounting principles, which generally is consistent with the matters listed in the application material of ISA 315. The proposed standard includes three additional matters relating to the accounts or disclosures in which judgment is used in the application of significant accounting principles, the degree of transparency of the application of significant accounting principles, and the financial reporting competencies of personnel involved in selecting and applying new or complex accounting principles.

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In obtaining an understanding of the control environment, ISA 315 requires the auditor to evaluate whether (a) management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and (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 control environment weaknesses. The proposed standard requires an additional assessment related to the control environment, but the requirement is aligned more closely with Auditing Standard No. 5.

The proposed standard and ISA 315 both require the auditor to obtain an understanding of the company's risk assessment process as part of obtaining an understanding of internal control. ISA 315 contains additional requirements for situations in which the company has no formal risk assessment process or a lack of documentation regarding the process. The proposed standard does not include these additional requirements because it is not necessary for the standards of audits of issuers to impose specific requirements based on the level of formality or documentation of the risk assessment component of internal control over financial reporting.

The proposed standard provides direction regarding the persons who should participate in the discussion among engagement team members about the risks of material misstatement, and such direction is not included in ISA 315. Also, the proposed standard carries forward the requirements in AU sec. 316 regarding the topics to be included in the discussion of fraud risks. ISA 240 provides guidance about topics to be discussed primarily in the application material.

ISA 315 requires the risk assessment procedures to include inquiries of management and others, analytical procedures, and observation and inspection. The proposed standard does not include this requirement. Rather, the requirements in the proposed standard, by their nature, should lead the auditor to perform a combination of those types of procedures.

The proposed standard and ISA 315 require the auditor to obtain an understanding of internal control. The proposed standard also indicates that the understanding should be sufficient 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. ISA 315 does not have similar direction with respect to the sufficiency of the auditor's understanding of internal control over financial reporting.

The proposed standard retains the requirement from AU section 316.29 to perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a

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material misstatement due to fraudulent financial reporting. The ISAs do not include this requirement.

In the requirements regarding the assessment of identified risks of material misstatement, the proposed standard directs the auditor to evaluate whether the risks of material misstatement at the financial statement level could result in risks of material misstatement at the assertion level. Also, the proposed standard requires auditors to identify significant accounts and disclosures and their relevant assertions. ISA 315 does not include these requirements.

The proposed standard does not include the appendix in ISA 315, containing descriptions of the components of internal control over financial reporting and examples of conditions and events that could indicate risks of misstatement. Instead, auditors should refer to the applicable internal control framework for information about internal control components.

Similarly, the proposed standard does not include the appendix in ISA 315 that lists risk indicators because the Board believes that auditors should focus on the risks that are relevant to the particular company rather than a generalized list of risk factors.

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

ISA 330, *The Auditor's Responses to Assessed Risks*, is the IAASB's auditing standard regarding the auditor's responses to risks of material misstatement. The following paragraphs discuss differences between the requirements in the proposed standard and those in ISA 330.

One important difference between the requirements of the proposed standard and those of the ISA is that the proposed standard contains key principles for responding to the risks of material misstatements in an integrated audit. For example, paragraph 7c of the proposed standard directs the auditor to design tests of controls to meet the objectives of both the audit of financial statements and the audit of internal control over financial reporting. ISA 330 addresses only audits of financial statements.

Another difference is that the ISA refers to the auditor's responses to "assessed" risks, whereas the proposed standard refers to responses to the 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, and this principle is separate from, but related to, the appropriateness of the auditor's risk assessments. The Board recognizes that if the auditor appropriately identifies and assesses the risks of material misstatement in accordance with the proposed standard on indentifying and assessing risks, then the auditor is in a better

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position to respond to the risks. On the other hand, noncompliance with the 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 respond to the risk of material misstatement in accordance with the proposed standard on auditor's responses.

ISA 330 indicates that the auditor implements overall responses to address risks at the financial statement level and responses involving the nature, timing, and extent of audit procedures to address risks at the assertion level. The Board believes that it is more important for the auditor to design and implement appropriate responses to the risks of material misstatement than to match the form of response to whether the risk is classified as a financial statement level risk or assertion level risk. Therefore, the proposed standard does not require the auditor to match overall responses to financial statement level risks and responses involving audit procedures to assertion level risks. Instead, the standard imposes a responsibility on the auditor to design and implement overall responses and responses involving audit procedures that address the risks of material misstatement. The proposed standard does not preclude the auditor from using overall responses to address risks at the financial statement level if those responses appropriately address the risks. However, an auditor cannot avoid performing audit procedures necessary to address a risk of material misstatement merely because the risk exists at the financial statement level.

In the direction on performing substantive procedures in response to significant risks, the proposed standard indicates that the substantive procedures should include tests of details. ISA 330 allows the auditor to address significant risks through a combination of tests of controls and substantive analytical procedures as an alternative to substantive tests of details.

As discussed previously, the requirements and direction regarding tests of controls in the proposed standard are aligned closely with the other risk assessment standards and Auditing Standard No. 5. Thus, the description of the requirements and direction in the proposed standard differs in some respects from the respective requirements and guidance in ISA 330. One significant procedural difference between the proposed standard and ISA 330 is that that ISA allows the auditor to use evidence from prior audits about operating effectiveness of controls without retesting, subject to certain conditions and limitations set forth in the standard. Like Auditing Standard No. 5, the proposed standard requires auditors to obtain evidence about controls selected for testing each year. However, the proposed standard contains direction for using evidence obtained in prior audits and varying the amount of evidence obtained based on factors set forth in the proposed standard.

Also, paragraph 49 of the proposed standard, which describes the auditor's responsibilities regarding performing substantive procedures before the end of the period, requires the auditor to compare relevant information about the account balance

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at the interim date with comparable information at the period end and to perform audit procedures to test the remaining period between the interim testing date and year end. ISA 330 imposes requirements for covering the remaining period, but the procedures involving comparing relevant information at the interim date to period-end information is included in the application material of the standard.

Proposed Auditing Standard – Evaluating Audit Results

The respective requirements in the ISAs relevant to the evaluation of audit results are –

- ISA 450, *Evaluation of Misstatements Identified During an Audit*
- ISA 330, *The 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*

The following paragraphs discuss differences between the requirements of the proposed standard and the respective requirements of the ISAs.

The proposed standard discusses the auditor's responsibilities for evaluating the results of integrated audits as well as audits of financial statements only. It discusses how the results of the audit of internal control can affect the evaluation of the results of the financial statement audit and vice versa.

ISA 450, paragraph A3, indicates that to assist the auditor in evaluating the effect of accumulated misstatements and communicating them to management and the audit committee, it may be useful to distinguish between factual misstatements, judgmental misstatements, and projected misstatements. The proposed standard describes three similar categories of misstatements like ISA 450 but does so in a general manner without applying defined terms.

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

The respective IAASB standard regarding consideration of materiality in planning and performing an audit is ISA 320, *Materiality in Planning and Performing an Audit*.

The introduction to ISA 320 discusses certain characteristics of materiality that the ISA indicates can provide a frame of reference if the concept of materiality is not discussed in the applicable financial reporting framework. Such a discussion is not

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needed in the Board's standards because the concept of materiality, as it applies under the federal securities laws, has been described by the U.S. Supreme Court.

ISA 320 contains a discussion of assumed characteristics of financial statement users. Such a discussion is not included in the proposed standard. Instead, the proposed standard refers to a "reasonable investor," which is consistent with the concept of materiality in the federal securities laws.

ISA 320 discusses, but does not require, the use of quantitative benchmarks in the determination of materiality for the financial statements as a whole. The proposed standard does not specifically discuss the use of quantitative benchmarks. Since the proposed standard neither requires nor prohibits the use of benchmarks, auditors may use them as long as the materiality level that they establish is appropriate and takes into account the surrounding circumstances, as discussed previously.

ISA 320 has a requirement similar to the proposed standard regarding the determination of tolerable misstatement, but the ISA uses the term "performance materiality." The proposed standard retains the term "tolerable misstatement," which is the term used in existing PCAOB standards.^{2/}

Proposed Auditing Standard – Audit Evidence

The respective IAASB standard is ISA 500, *Audit Evidence*. The proposed standard is similar in many respects to ISA 500. The following are the primary differences between the proposed standard and ISA 500:

- The objective was revised to use the formulation of obtaining sufficient appropriate audit evidence "to support the opinion," which is more consistent with the requirements in the proposed standard on evaluating audit results and Auditing Standard No. 5.
- The standard describes financial statement assertions using the five categories of assertions in Auditing Standard No. 5 and AU sec. 326 instead of the 13 categories in ISA 500. However, the proposed standard would not preclude auditors from using the 13 categories in the ISAs.

ISA 500 includes direction regarding using the work of "management's expert." Establishing requirements and providing direction regarding using the work of a specialist is the subject of another standards project, so the proposed standard does not include additional direction on that subject. However, certain paragraphs of the

^{2/} AU sec. 350, *Audit Sampling*.

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proposed standard mention using the work of a specialist as audit evidence and refer the reader to AU sec. 336 for the relevant requirements.