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Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards; Notice

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–62919; File No. PCAOB–2010–01]

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards

September 15, 2010.

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on September 15, 2010, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission") the proposed rules described in Items I and II below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rules

On August 5, 2010, the Board adopted the following eight auditing standards:

- Auditing Standard No. 8, *Audit Risk*
- Auditing Standard No. 9, *Audit Planning*
- Auditing Standard No. 10, *Supervision of the Audit Engagement*
- Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*
- Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*
- Auditing Standard No. 14, *Evaluating Audit Results*
- Auditing Standard No. 15, *Audit Evidence*

(collectively referred to as the "Risk Assessment Standards"); and amendment to the Board's interim auditing standards (collectively, "the proposed rules "). The text of the Risk Assessment Standards and amendments to the Board's interim auditing standards are set out below.

Auditing Standard No. 8

Audit Risk

Introduction

1. This standard discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit [1] or an audit of financial statements only.

Objective

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

Audit Risk

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

4. In an audit of financial statements, audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, i.e., the financial statements are not presented fairly in conformity with the applicable financial reporting framework. Audit risk is a function of the risk of material misstatement and detection risk.

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

Risk of Material Misstatement

5. The risk of material misstatement refers to the risk that the financial statements are materially misstated. Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* indicates that the auditor should assess the risks of material misstatement at two levels: (1) At the financial statement level and (2) at the assertion [4] level.[5]

6. Risks of material misstatement at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of material misstatement at the financial statement level may be especially relevant to the auditor's consideration of the risk of material misstatement due to fraud. For example, an ineffective control environment, a lack of sufficient capital to continue operations, and declining conditions affecting the company's industry might create pressures or opportunities for management to manipulate the financial statements, leading to higher risk of material misstatement.

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

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

b. *Control risk,* which is the risk that a misstatement due to error or fraud that could occur in an assertion and that could be material, individually or in 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 related to the company, its environment, and its internal control, and the auditor assesses those risks based on evidence he or she obtains. The auditor assesses inherent risk using information obtained from performing risk assessment procedures and considering the characteristics of the accounts and disclosures in the financial statements.[6] The auditor assesses control risk using evidence obtained from tests of controls (if the auditor plans to rely on those controls to assess control risk at less than maximum) and from other sources.[7]

Detection Risk

9. In an audit of financial statements, detection risk is the risk that the procedures performed by the auditor will not detect a misstatement that exists and that could be material, individually or in combination with other misstatements. Detection risk is affected by (1) the effectiveness of the

[1] When the auditor is performing an integrated audit of financial statements and internal control over financial reporting, the requirements in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* also apply. However, the risks of material misstatement of the financial statements are the same for both the audit of financial statements and the audit of internal control over financial reporting.

[2] Misstatement is defined in Appendix A of Auditing Standard No. 14, *Evaluating Audit Results.*

[3] *See* AU sec. 110, *Responsibilities and Functions of the Independent Auditor,* and paragraph .10 of AU sec. 230, *Due Professional Care in the Performance of Work,* for a further discussion of reasonable assurance.

[4] *See* Auditing Standard No. 15, *Audit Evidence,* for a description of financial statement assertions.

[5] Paragraph 59 of Auditing Standard No. 12.

[6] Paragraph 59.a. of Auditing Standard No. 12.

[7] Paragraphs 32–34 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

substantive procedures and (2) their application by the auditor, i.e., whether the procedures were performed with due professional care.

10. The auditor uses the assessed risk of material misstatement to determine the appropriate level of detection risk for a financial statement assertion. The higher the risk of material misstatement, the lower the level of detection risk needs to be in order to reduce audit risk to an appropriately low level.

11. The auditor reduces the level of detection risk through the nature, timing, and extent of the substantive procedures performed. As the appropriate level of detection risk decreases, the evidence from substantive procedures that the auditor should obtain increases.[8]

Auditing Standard No. 9

Audit Planning

Introduction

1. This standard establishes requirements regarding planning an audit.

Objective

2. The objective of the auditor is to plan the audit so that the audit is conducted effectively.

Responsibility of the Engagement Partner for Planning

3. The **engagement partner** [9] is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for planning the audit and may seek assistance from appropriate engagement team members in fulfilling this responsibility. Engagement team members who assist the engagement partner with audit planning also should comply with the relevant requirements in this standard.

Planning an Audit

4. The auditor should properly plan the audit. This standard describes the auditor's responsibilities for properly planning the audit.[10]

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

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,[11]

b. Determine compliance with independence and ethics requirements, and

Note: The determination of compliance with independence and ethics requirements is not limited to preliminary engagement activities and should be reevaluated with changes in circumstances.

c. Establish an understanding with the client regarding the services to be performed on the engagement.[12]

Planning Activities

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

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality,[13] risk, and, in integrated audits, other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee [14] 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.

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

Audit Strategy

8. The auditor should establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan.

9. In establishing the overall audit strategy, the auditor should take into account:

a. The reporting objectives of the engagement and the nature of the communications required by PCAOB standards,[15]

[8] Paragraph 37 of Auditing Standard No. 13.

[9] Terms defined in Appendix A, *Definitions,* are set in boldface type the first time they appear.

[10] The term, "auditor," as used in this standard, encompasses both the engagement partner and the engagement team members who assist the engagement partner in planning the audit.

[11] 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.

[12] AU sec. 310, *Appointment of the Independent Auditor.*

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

[14] If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company. *See* 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

[15] *See, e.g.,* AU sec. 310 and AU sec. 380, *Communication With Audit Committees.* Also, various laws or regulations require other matters to be communicated. (*See, e.g.,* Rule 2–07 of Regulation S–X, 17 CFR 210.2–07; and Rule 10A–3 under the Securities Exchange Act of 1934, 17 CFR 240.10A–3.) The requirements of this standard do not modify communications required by those other laws or regulations.

b. The factors that are significant in directing the activities of the engagement team,[16]

c. The results of preliminary engagement activities [17] and the auditor's evaluation of the important matters in accordance with paragraph 7 of this standard, and

d. The nature, timing, and extent of resources necessary to perform the engagement.[18]

Audit Plan

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

a. The planned nature, timing, and extent of the risk assessment procedures; [19]

b. The planned nature, timing, and extent of tests of controls and substantive procedures; [20] and

c. Other planned audit procedures required to be performed so that the engagement complies with PCAOB standards.

Multi-Location Engagements

11. In an audit of the financial statements of a company with operations in multiple locations or business units,[21] the auditor should determine the extent to which audit 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. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual locations or business units. The auditor should assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit.

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

a. The nature and amount of assets, liabilities, and transactions executed at the location or business unit, including, e.g., significant transactions executed at the location or business unit that are outside the normal course of business for the company, or that otherwise appear to be unusual given the auditor's understanding of the company and its environment; [22]

b. The materiality of the location or business unit; [23]

c. The specific risks associated with the location or business unit that present a reasonable possibility[24] of material misstatement to the company's consolidated financial statements;

d. Whether the risks of material misstatement associated with the location or business unit apply to other locations or business units such that, in combination, they present a reasonable possibility of material misstatement to the company's consolidated financial statements;

e. The degree of centralization of records or information processing;

f. The effectiveness of the control environment, particularly with respect to management's control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or business unit; and

g. The frequency, timing, and scope of monitoring activities by the company or others at the location or business unit.

Note: When performing an audit of internal control over financial reporting, refer to Appendix B, Special Topics, of Auditing Standard No. 5[25] for considerations when a company has multiple locations or business units.

13. In determining the locations or business units at which to perform audit procedures, the auditor may take into account relevant activities performed by internal audit, as described in AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* or others, as described in Auditing Standard No. 5. AU sec. 322 and Auditing Standard No. 5 establish requirements regarding using the work of internal audit and others, respectively.

14. AU sec. 543, *Part of Audit Performed by Other Independent Auditors,* describes the auditor's responsibilities regarding using the work and reports of other independent auditors who audit the financial statements of one or more of the locations or business units that are included in the consolidated financial statements.[26] In those situations, the auditor should perform the procedures in paragraphs 11–13 of this standard to determine the locations or business units at which audit procedures should be performed.

Changes During the Course of the Audit

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

Persons With Specialized Skill or Knowledge

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

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

a. Communicate the objectives of that person's work;

b. Determine whether that person's procedures meet the auditor's objectives; and

c. Evaluate the results of that person's procedures as they relate to the nature, timing, and extent of other planned audit procedures and the effects on the auditor's report.

Additional Considerations in Initial Audits

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

[16] *See, e.g.,* paragraph 6 of Auditing Standard No. 10, *Supervision of the Audit Engagement.*

[17] Paragraph 6 of this standard.

[18] *See, e.g.,* paragraph .06 of AU sec. 230, *Due Professional Care in the Performance of Work,* paragraph 16 of this standard, and paragraph 5.a. of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

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

[20] Auditing Standard No. 13 and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

[21] The term "business units" includes subsidiaries, divisions, branches, components, or investments.

[22] Paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*

[23] Paragraph 10 of Auditing Standard No. 11 describes the consideration of materiality in planning and performing audit procedures at an individual location or business unit.

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

[25] Paragraphs B10–B16 of Auditing Standard No. 5.

[26] For integrated audits, *see also* paragraphs C8–C11 of Auditing Standard No. 5.

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.*

19. The purpose and objective of planning the audit are the same for an initial audit or a recurring audit engagement. However, for an initial audit, the auditor should determine the additional planning activities necessary to establish an appropriate audit strategy and audit plan, including determining the audit procedures necessary to obtain sufficient appropriate audit evidence regarding the opening balances.[27]

Appendix A—Definition

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Engagement partner—The member of the engagement team with primary responsibility for the audit.

Auditing Standard No. 10

Supervision of the Audit Engagement

Introduction

1. This standard establishes requirements regarding supervision of the audit engagement, including supervising the work of engagement team members.

Objective

2. The objective of the auditor is to supervise the audit engagement, including supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.

Responsibility of the Engagement Partner for Supervision

3. The **engagement partner**[28] is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for proper supervision of the work of engagement team members and for compliance with PCAOB standards, including standards regarding using the work of specialists,[29] other auditors,[30] internal auditors,[31] and others who are involved in testing controls.[32] Paragraphs 5–6 of this standard describe the nature and extent of supervisory activities necessary for proper supervision of engagement team members.[33]

4. The engagement partner may seek assistance from appropriate engagement team members in fulfilling his or her responsibilities pursuant to this standard. Engagement team members who assist the engagement partner with supervision of the work of other engagement team members also should comply with the requirements in this standard with respect to the supervisory responsibilities assigned to them.

Supervision of Engagement Team Members

5. The engagement partner and, as applicable, other engagement team members performing supervisory activities, should:

a. Inform engagement team members of their responsibilities,[34] including:

(1) The objectives of the procedures that they are to perform;

(2) The nature, timing, and extent of procedures they are to perform; and

(3) Matters that could affect the procedures to be performed or the evaluation of the results of those procedures, including relevant aspects of the company, its environment, and its internal control over financial reporting,[35] and possible accounting and auditing issues;

b. Direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities so they can evaluate those issues and determine that appropriate actions are taken in accordance with PCAOB standards;[36]

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

c. Review the work of engagement team members to evaluate whether:

(1) The work was performed and documented;

(2) The objectives of the procedures were achieved; and

(3) The results of the work support the conclusions reached.[37]

6. To determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, the engagement partner and other engagement team members performing supervisory activities should take into account:

a. The nature of the company, including its size and complexity;[38]

b. The nature of the assigned work for each engagement team member, including:

(1) The procedures to be performed, and

(2) The controls or accounts and disclosures to be tested;

c. The risks of material misstatement; and

d. The knowledge, skill, and ability of each engagement team member.[39]

Note: In accordance with the requirements of paragraph 5 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement,* the extent of supervision of engagement team members should be commensurate with the risks of material misstatement.[40]

Appendix A—Definition

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Engagement partner—The member of the engagement team with primary responsibility for the audit.

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[27] *See also* paragraph 3 of Auditing Standard No. 6, *Evaluating Consistency of Financial Statements.*

[28] Terms defined in Appendix A, *Definitions,* are set in boldface type the first time they appear.

[29] AU sec. 336, *Using the Work of a Specialist.*

[30] AU sec. 543, *Part of Audit Performed by Other Independent Auditors.*

[31] AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.*

[32] Paragraphs 16–19 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

[33] *See also* paragraph .06 of AU sec. 230, *Due Professional Care in the Performance of Work.*

[34] AU sec. 230.06 and paragraph 5 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement,* establish requirements regarding the appropriate assignment of engagement team members.

[35] Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* describes the auditor's responsibilities for obtaining an understanding of the company, its environment, and its internal control over financial reporting.

[36] *See, e.g.,* paragraph 15 of Auditing Standard No. 9, *Audit Planning,* paragraph 74 of Auditing Standard No. 12, and paragraphs 20–23 and 35–36 of Auditing Standard No. 14, *Evaluating Audit Results.*

[37] Auditing Standard No. 14 describes the auditor's responsibilities for evaluating the results of the audit, and Auditing Standard No. 3, *Audit Documentation,* establishes requirements regarding audit documentation.

[38] Paragraph 10 of Auditing Standard No. 12.

[39] *See also* paragraph 5.a. of Auditing Standard No. 13 and AU sec. 230.06.

[40] Paragraph 5.b. of Auditing Standard No. 13 indicates that the extent of supervision of engagement team members is part of the auditor's overall responses to the risks of material misstatement.

Auditing Standard No. 11

Consideration of Materiality in Planning and Performing an Audit

Introduction

1. This standard establishes requirements regarding the auditor's consideration of materiality in planning and performing an audit.[41]

Materiality in the Context of an Audit

2. In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the * * * fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." [42] 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 * * *." [43]

3. To obtain reasonable assurance about whether the financial statements are free of material misstatement, the auditor should plan and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements. This includes being alert while planning and performing audit procedures for misstatements that could be material due to quantitative or qualitative factors. Also, the evaluation of uncorrected misstatements in accordance with Auditing Standard No. 14, *Evaluating Audit Results,* requires consideration of both qualitative and quantitative factors.[44] However, it ordinarily is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors.

4. For integrated audits, Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* states, "In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements." [45]

Objective

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

Considering Materiality in Planning and Performing an Audit

Establishing a Materiality Level for the Financial Statements as a Whole

6. To plan the nature, timing, and extent of audit procedures, the auditor should establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This includes consideration of the company's earnings and other relevant factors. To determine the nature, timing, and extent of audit procedures, the materiality level for the financial statements as a whole needs to be expressed as a specified amount.

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

Establishing Materiality Levels for Particular Accounts or Disclosures

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

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

Determining Tolerable Misstatement

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

9. In determining tolerable misstatement and planning and performing audit procedures, the auditor should take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods.

Considerations for Multi-Location Engagements

10. For purposes of the audit of the consolidated financial statements of a company with multiple locations or business units, the auditor should determine tolerable misstatement for the individual locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements. Accordingly, tolerable misstatement at an individual location should be less than the materiality level for the financial statements as a whole.

Considerations as the Audit Progresses

11. The auditor should reevaluate the established materiality level or levels and tolerable misstatement when, because of changes in the particular circumstances or additional information that comes to the auditor's attention, there is a substantial likelihood that misstatements of amounts that differ significantly from the materiality level or levels that were established initially would influence the judgment of a reasonable investor. Situations in which changes in circumstances or additional information that comes to the auditor's attention would require such reevaluation include:

a. The materiality level or levels and tolerable misstatement were established initially based on estimated or preliminary financial statement amounts that differ significantly from actual amounts.

b. Events or changes in conditions occurring after the materiality level or levels and tolerable misstatement were established initially are likely to affect

[41] Auditing Standard No. 14 establishes requirements regarding the auditor's consideration of materiality in evaluating audit results.

[42] *TSC Industries* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976). *See also Basic, Inc.* v. *Levinson,* 485 U.S. 224 (1988).

[43] *TSC Industries,* 426 U.S. at 450.

[44] Appendix B of Auditing Standard No. 14.

[45] Paragraph 20 of Auditing Standard No. 5.

investors' perceptions about the company's financial position, results of operations, or cash flows.

Note: Examples of such events or changes in conditions include (1) changes in laws, regulations, or the applicable financial reporting framework that affect investors' expectations about the measurement or disclosure of certain items and (2) significant new contractual arrangements that draw attention to a particular aspect of a company's business that is separately disclosed in the financial statements.

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

Note: The reevaluation of the materiality level or levels and tolerable misstatement is also relevant to the auditor's evaluation of uncorrected misstatements in accordance with Auditing Standard No. 14.[46]

Auditing Standard No. 12

Identifying and Assessing Risks of Material Misstatement

Introduction

1. This standard establishes requirements regarding the process of identifying and assessing risks of material misstatement[47] of the financial statements.

2. Paragraphs 4–58 of this standard discuss the auditor's responsibilities for performing **risk assessment procedures**.[48] Paragraphs 59–73 of this standard discuss identifying and assessing the risks of material misstatement using information obtained from performing risk assessment procedures.

Objective

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

[46] Paragraph 17 of Auditing Standard No. 14.

[47] Paragraphs 5–8 of Auditing Standard No. 8, *Audit Risk.*

[48] Terms defined in Appendix A, *Definitions,* are set in boldface type the first time they appear.

Performing Risk Assessment Procedures

4. The auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud,[49] and designing further audit procedures.[50]

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

a. Obtaining an understanding of the company and its environment (paragraphs 7–17);

b. Obtaining an understanding of internal control over financial reporting (paragraphs 18–40);

c. Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company (paragraphs 41–45);

d. Performing analytical procedures (paragraphs 46–48);

e. Conducting a discussion among engagement team members regarding the risks of material misstatement (paragraphs 49–53); and

f. Inquiring of the audit committee, management, and others within the company about the risks of material misstatement (paragraphs 54–58).

[49] 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.

[50] Auditing Standard No. 15, *Audit Evidence,* describes further audit procedures as consisting of tests of controls and substantive procedures.

Note: This standard describes an approach to identifying and assessing risks of material misstatement that begins at the financial statement level and with the auditor's overall understanding of the company and its environment and works down to the significant accounts and disclosures and their relevant assertions.[51]

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

Obtaining an Understanding of the Company and Its Environment

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

a. Relevant industry, regulatory, and other external factors;

b. The nature of the company;

c. The company's selection and application of accounting principles, including related disclosures;

d. The **company's objectives and strategies** and those related **business risks** that might reasonably be expected to result in risks of material misstatement; and

e. The company's measurement and analysis of its financial performance.

8. In 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

9. Obtaining an understanding of relevant industry, regulatory, and other external factors encompasses industry factors, including the competitive environment and technological developments; the regulatory environment, including the applicable

[51] Paragraph 11 of Auditing Standard No. 15 discusses financial statement assertions.

financial reporting framework[52] and the legal and political environment;[53] and external factors, including general economic conditions.

Nature of the Company

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

• 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, noncapital funding (e.g., subordinated debt or dependencies on supplier financing), and other debt instruments;

• The company's significant investments, including equity method investments, joint ventures, and variable interest entities;

• The company's operating characteristics, including its size and complexity;

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

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

• Key supplier and customer relationships.

Note: The auditor should take into account the information gathered while obtaining an understanding of the nature of the company when determining the existence of related parties in accordance with AU sec. 334, *Related Parties.*

11. As part of obtaining an understanding of the company as required by paragraph 7, the auditor should consider performing the following procedures and the extent to which the procedures should be performed:

• Reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and, in an integrated audit, the effectiveness of the company's internal control over financial reporting, e.g., company-issued press releases, company-prepared presentation materials for analysts or investor groups, and analyst reports;

• Observing or reading transcripts of earnings calls and, to the extent publicly available, other meetings with investors or rating agencies;

• Obtaining an understanding of compensation arrangements with senior management, including incentive compensation arrangements, changes or adjustments to those arrangements, and special bonuses; and

• Obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders to identify potentially significant unusual developments (e.g., from Forms 3, 4, 5, 13D, and 13G).

Selection and Application of Accounting Principles, Including Related Disclosures

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

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

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

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

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

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

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

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

Company Objectives, Strategies, and Related Business Risks

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

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.

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

• Industry developments (a potential related business risk might be, e.g., 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, e.g., that the new product or service will not be successful.)

• Use of information technology ("IT") (a potential related business risk might be, e.g., that systems and processes are incompatible.)

• New accounting requirements (a potential related business risk might be, e.g., incomplete or improper implementation of a new accounting requirement.)

• Expansion of the business (a potential related business risk might be, e.g., that the demand for the company's products or services has not been accurately estimated.)

• The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, e.g., incomplete or improper implementation of the strategy.)

• Current and prospective financing requirements (a potential related business risk might be, e.g., the loss of financing due to the company's inability to meet financing requirements.)

• Regulatory requirements (a potential related business risk might be, e.g., that there is increased legal exposure.)

Note: Business risks could affect risks of material misstatement at the financial statement level, which would affect many accounts and disclosures in the financial statements. For example, a company's loss of financing or declining conditions affecting the company's

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

[53] AU sec. 317, *Illegal Acts by Clients,* discusses the auditor's consideration of laws and regulations relevant to the audit.

industry could affect its ability to settle its obligations when due. This, in turn, could affect the risks of material misstatement related to, e.g., the classification of long-term liabilities or valuation of long-term assets, or it could result in substantial doubt about the company's ability to continue as a going concern. Other business risks could affect the risks of material misstatement for particular accounts, disclosures, or assertions. For example, an unsuccessful new product or service or failed business expansion might affect the risks of material misstatement related to the valuation of inventory and other related assets.

Company Performance Measures

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

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

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

Note: The first two examples represent performance measures that can affect the risks of material misstatement by creating incentives or pressures for management of the company to manipulate certain accounts or disclosures to achieve certain performance targets (or conceal a failure to achieve those targets). The third example represents performance measures that management might use to monitor risks affecting the financial statements.

Note: Smaller companies might have less formal processes to measure and review financial performance. In such cases, the auditor might identify relevant performance measures by considering the information that the company uses to manage the business.

Obtaining an Understanding of Internal Control Over Financial Reporting

18. The auditor should obtain a sufficient understanding of each component [54] of internal control over financial reporting ("understanding of internal control") to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.

19. The nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control depend on the size and complexity of the company; [55] 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 IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting.

Note: The auditor also might obtain an understanding of certain controls that are not part of internal control over financial reporting, e.g., controls over the completeness and accuracy of operating or other nonfinancial information used as audit evidence.[56]

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

Note: Procedures the auditor performs to obtain evidence about design effectiveness include inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs, as described in paragraphs 37–38, that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Note: Determining whether a control has been implemented means determining whether the control exists and whether the company is using it. The procedures to determine whether a control has been implemented may be performed in connection with the evaluation of its design. Procedures performed to determine whether a control has been implemented include inquiry of appropriate personnel, in combination with observation of the application of controls or inspection of documentation. Walkthroughs, as described in paragraphs 37–38, that include these procedures ordinarily are sufficient to determine whether a control has been implemented.

21. Internal control over financial reporting can be described as consisting of the following components: [57]

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

22. Management might use an internal control framework with components that differ from the components identified in the preceding paragraph when establishing and maintaining the company's internal control over financial reporting. In evaluating the design of controls and determining whether they have been implemented in an audit of financial statements only, the auditor may use the framework used by management or another suitable, recognized framework.[58] For integrated audits, Auditing Standard No. 5, states, "The auditor should use the same suitable, recognized control framework to perform his or her 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." [59] If the auditor uses a suitable, recognized internal control framework with components that differ from those listed in the preceding paragraph, the auditor should adapt the requirements in paragraphs 23–36 of this standard to conform to the components in the framework used.

Control Environment

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

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

- 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

[54] Paragraphs 21–22 of this standard discuss components of internal control over financial reporting.

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

[56] Paragraph 10 of Auditing Standard No. 15.

[57] Different internal control frameworks use different terms and approaches to describe the components of internal control over financial reporting.

[58] *See* Securities Exchange Act Release No. 34–47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

[59] Paragraph 5 of Auditing Standard No. 5.

understanding the control environment, in accordance with paragraph 23, and the other relevant knowledge possessed by the auditor. In an integrated audit of financial statements and internal control over financial reporting, Auditing Standard No. 5 [60] describes the auditor's responsibility for evaluating the control environment.

25. If the auditor identifies a control deficiency [61] 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 65–66 of this standard.

The Company's Risk Assessment Process

26. The auditor should obtain an understanding of management's process for:

a. Identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud ("fraud risks");

b. Assessing the likelihood and significance of misstatements resulting from those risks; and

c. Deciding about actions to address those risks.

27. Obtaining an understanding of the company's risk assessment process includes obtaining an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.

Information and Communication

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

a. The classes of transactions in the company's operations that are significant to the financial statements;

b. The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported;

c. The related accounting records, supporting information, and specific accounts in the financial statements that are used to initiate, authorize, process, and record transactions;

d. How the information system captures events and conditions, other than transactions,[62] that are significant to the financial statements; and

e. The period-end financial reporting process.

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

29. The auditor also should obtain an understanding of how IT affects the company's flow of transactions. (See Appendix B.)

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

30. A company's business processes are the activities designed to:

a. Develop, purchase, produce, sell and distribute a company's products or services;

b. Record information, including accounting and financial reporting information; and

c. Ensure compliance with laws and regulations relevant to the financial statements.

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

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

- Procedures used to enter transaction totals into the general ledger;
- Procedures related to the selection and application of accounting principles; [63]
- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- Procedures used to record recurring and nonrecurring adjustments to the annual financial statements (and quarterly financial statements, if applicable); and
- Procedures for preparing annual financial statements and related disclosures (and quarterly financial statements, if applicable).

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 to relevant company personnel and others, including:

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

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 18 of this standard.[64] As the auditor obtains an understanding of the other components of internal control over financial reporting, he or she is also likely to obtain knowledge about some control activities. The auditor should use his or her knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control over financial reporting in determining the extent to which it is necessary to devote additional attention to obtaining an understanding of control activities to assess the factors that affect the risks of material misstatement and to design further audit procedures.

Note: A broader understanding of control activities is needed for relevant assertions for which the auditor plans to rely on controls. Also, in the audit of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit.

Monitoring of Controls

35. The auditor should obtain an understanding of the major types of activities that the company uses to monitor the effectiveness of its internal control over financial reporting and how the company initiates corrective actions related to its controls.[65]

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

Performing Walkthroughs

37. As discussed in paragraph 20, the auditor may perform walkthroughs as part of obtaining an understanding of internal control over financial reporting. For example, the auditor may perform walkthroughs in connection with understanding the flow of transactions

[60] Paragraph 25 of Auditing Standard No. 5.

[61] Paragraph A3 of Auditing Standard No. 5.

[62] Examples of such events and conditions include depreciation and amortization and conditions affecting the recoverability of assets.

[63] Paragraphs 12–13 of this standard.

[64] *Also see* paragraph B5 of Appendix B of this standard.

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

in the information system relevant to financial reporting, evaluating the design of controls relevant to the audit, and determining whether those controls have been implemented. In performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and IT that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

Note: For integrated audits, Auditing Standard No. 5 establishes certain objectives that the auditor should achieve to further understand likely sources of potential misstatements and as part of selecting the controls to test. Auditing Standard No. 5 states that performing walkthroughs will frequently be the most effective way of achieving those objectives.[66]

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

Relationship of Understanding of Internal Control to Tests of Controls

39. The objective of obtaining an understanding of internal control, as discussed in paragraph 18 of this standard, is different from testing controls for the purpose of assessing control risk[67] or for the purpose of expressing an opinion on internal control over financial reporting in the audit of internal control over financial reporting.[68] The auditor may obtain an understanding of internal control concurrently with performing tests of controls if he or she obtains sufficient appropriate evidence to achieve the objectives of both procedures. Also, the auditor should take into account the evidence obtained from understanding internal control when assessing control risk and, in the audit of internal control over financial reporting, forming an opinion about the effectiveness of internal control over financial reporting.

40. *Relationship of Understanding of Internal Control to Evaluating Entity-Level Controls in an Audit of Internal Control Over Financial Reporting.* Auditing Standard No. 5 states, "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."[69] The procedures performed to obtain an understanding of certain components of internal control in accordance with this standard, e.g., the control environment, the company's risk assessment process, information and communication, and monitoring of controls, might provide evidence that is relevant to the auditor's evaluation of entity-level controls.[70] The auditor should take into account the evidence obtained from understanding internal control when determining the nature, timing, and extent of procedures necessary to support the auditor's conclusions about the effectiveness of entity-level controls in the audit of internal control over financial reporting.

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

41. *Client Acceptance and Retention and Audit Planning Activities.* The auditor should evaluate whether information obtained from the client acceptance and retention evaluation 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 beginning in paragraph 59 of this standard.

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

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

44. *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.

45. The auditor should obtain an understanding of the nature of the services that have been performed for the company by the auditor or affiliates of the firm[71] and should take into account relevant information obtained from those engagements in identifying risks of material misstatement.[72]

Performing Analytical Procedures

46. The auditor should perform analytical procedures that are designed to:

a. Enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior year end; and

b. Identify areas that might represent specific risks relevant to the audit, including the existence of unusual transactions and events, and amounts, ratios, and trends that warrant investigation.

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

48. When performing an analytical procedure, the auditor should use his or

[66] *See* paragraphs 34–38 of Auditing Standard No. 5.

[67] Paragraphs 16–35 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

[68] Paragraph B1 of Auditing Standard No. 5.

[69] Paragraph 22 of Auditing Standard No. 5.

[70] The entity-level controls included in paragraph 24 of Auditing Standard No. 5 include controls related to the control environment; the company's risk assessment process; centralized processing and controls; controls over the period-end financial reporting process; and controls to monitor other controls.

[71] *See* PCAOB Rule 3501(a)(i), which defines "affiliate of the accounting firm."

[72] Paragraph 7 of Auditing Standard No. 9, *Audit Planning.*

her understanding of the company to develop expectations about plausible relationships among the data to be used in the procedure.[73] 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.

Note: Analytical procedures performed as risk assessment procedures often use data that is preliminary or data that is aggregated at a high level, and, in those instances, such analytical procedures are not designed with the level of precision necessary for substantive analytical procedures.

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

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

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.[74]

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

50. Key engagement team members include all engagement team members who have significant engagement responsibilities, including the engagement partner. The manner in which the discussion is 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 evaluating the susceptibility of the company's financial statements to material misstatement.

51. Communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change.[75]

Discussion of the Potential for Material Misstatement Due to Fraud

52. The discussion among the key engagement team members about the potential for material misstatement due to fraud should occur with an attitude that includes a questioning mind, and the key engagement team members should set aside any prior beliefs they might have that management is honest and has integrity. The discussion among the key engagement team members should include:

- An exchange of ideas, or "brainstorming," among the key engagement team members, including the engagement partner, about how and where they believe the company's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the company could be misappropriated, including (a) the susceptibility of the financial statements to material misstatement through related party transactions and (b) how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures;
- 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; and
- A consideration of the potential audit responses to the susceptibility of the company's financial statements to material misstatement due to fraud.

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

- The need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, as described in AU sec. 316;[76]
- The need to be alert for information or other conditions (such as those matters presented in Appendix C of Auditing Standard No. 14) that might affect the assessment of fraud risks; and
- If information or other conditions indicate that 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.[77]

Inquiring of the Audit Committee, Management, and Others Within the Company About the Risks of Material Misstatement

54. The auditor should inquire of the audit committee, or equivalent (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.

55. 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 the inquiries about risks of material misstatement.

Inquiries Regarding Fraud Risks

56. 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 fraud risks 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

[73] Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.

[74] Paragraphs 52–53 of this standard.

[75] *See also* paragraph 29 of Auditing Standard No. 14, *Evaluating Audit Results.*

[76] AU sec. 316.13.

[77] Paragraphs 20–23 of Auditing Standard No. 14 establish further requirements for evaluating whether misstatements might be indicative of fraud and determining the necessary procedures to be performed in those situations.

are particular operating locations or business segments for which a fraud risk might be more likely to exist;

(5) Whether and how management communicates to employees its views on business practices and ethical behavior;

(6) Whether management has received tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, management's responses to such tips and complaints; and

(7) Whether management has reported to the audit committee on how the company's internal control serves to prevent and detect material misstatements due to fraud.

b. Inquiries of the audit committee, or equivalent, or its chair regarding:

(1) The audit committee's views about fraud risks in the company;

(2) Whether the audit committee has knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

(3) Whether the audit committee is aware of tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, the audit committee's responses to such tips and complaints; and

(4) How the audit committee exercises oversight of the company's assessment of fraud risks and the establishment of controls to address fraud risks.

c. If the company has an internal audit function, inquiries of appropriate internal audit personnel regarding:

(1) The internal auditors' views about fraud risks in the company;

(2) Whether the internal auditors have knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

(3) Whether internal auditors have performed procedures to identify or detect fraud during the year, and whether management has satisfactorily responded to the findings resulting from those procedures; and

(4) Whether internal auditors are aware of instances of management override of controls and the nature and circumstances of such overrides.

57. In addition to the inquiries outlined in the preceding paragraph, the auditor should inquire of others within the company about their views regarding fraud risks, including, in particular, whether they have knowledge of fraud, alleged fraud, or suspected fraud. The auditor should identify other individuals within the company to whom inquiries should be directed and determine the extent of such inquiries by considering whether others in the company might have additional knowledge about fraud, alleged fraud, or suspected fraud or might be able to corroborate fraud risks identified in discussions with management or the audit committee. Examples of other individuals within the company to whom inquiries might be directed include:

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

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

Identifying and Assessing the Risks of Material Misstatement

59. The auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level. In identifying and assessing risks of material misstatement, the auditor should:

a. Identify risks of misstatement using information obtained from performing risk assessment procedures (as discussed in paragraphs 4–58) and considering the characteristics of the accounts and disclosures in the financial statements.

Note: Factors relevant to identifying fraud risks are discussed in paragraphs 65–69 of this standard.

b. Evaluate whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions.

c. Evaluate the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected.

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

d. Assess the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements.

Note: In assessing the likelihood and magnitude of potential misstatement, the auditor may take into account the planned degree of reliance on controls selected to test.[78]

e. Identify significant accounts and disclosures [79] and their relevant assertions [80] (paragraphs 60–64 of this standard).

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.

f. Determine whether any of the identified and assessed risks of material misstatement are SIGNIFICANT RISKS (paragraphs 70–71 of this standard).

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

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

- Size and composition of the account;
- Susceptibility to misstatement due to error or fraud;

[78] Paragraphs 16–35 of Auditing Standard No. 13.

[79] Paragraph A10 of Auditing Standard No. 5 states:

An account or disclosure is a significant account or disclosure if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.

[80] Paragraph A9 of Auditing Standard No. 5 states:

A relevant assertion is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

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

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

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

Note: In the financial statement audit, the auditor might perform substantive auditing procedures on financial statement accounts, disclosures, and assertions that are not determined to be significant accounts and disclosures and relevant assertions.[81]

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

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

Factors Relevant to Identifying Fraud Risks

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

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

66. All three conditions discussed in the preceding paragraph are not required to be observed or evident to conclude that a fraud risk exists. The auditor might conclude that a fraud risk exists even when only one of these three conditions is present.

67. *Consideration of the Risk of Omitted, Incomplete, or Inaccurate Disclosures.* The auditor's evaluation of fraud risk factors in accordance with paragraph 65 should include evaluation of how fraud could be perpetrated or concealed by presenting incomplete or inaccurate disclosures or by omitting disclosures that are necessary for the financial statements to be presented fairly in conformity with the applicable financial reporting framework.

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

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

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

Factors Relevant To Identifying Significant Risks

70. To determine whether an identified and assessed risk is a significant risk, the auditor should evaluate whether the risk requires special audit consideration because of the nature of the risk or the likelihood and potential magnitude of misstatement related to the risk.

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

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

a. The effect of the quantitative and qualitative risk factors discussed in paragraph 60 on the likelihood and potential magnitude of misstatements;

b. Whether the risk is a fraud risk;

Note: A fraud risk is a significant risk.

c. Whether the risk is related to recent significant economic, accounting, or other developments;

d. The complexity of transactions;

e. Whether the risk involves significant transactions with related parties;

f. 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

g. Whether the risk involves significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature.

Further Consideration of Controls

72. When the auditor has determined that a significant risk, including a fraud risk, exists, the auditor should evaluate the design of the company's controls that are intended to address fraud risks and other significant risks and determine whether those controls have been implemented, if the auditor has not already done so when obtaining an understanding of internal control, as described in paragraphs 18–40 of this standard.[82]

73. Controls that address fraud risks include (a) specific controls designed to

[81] The auditor might perform substantive auditing procedures because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high or as a means of introducing unpredictability in the procedures performed. *See* paragraphs 11, 14, and 25 of Auditing Standard No. 14, for further discussion about undetected misstatement. *See* paragraph 61 of Auditing Standard No. 5 and paragraph 5.c. of Auditing Standard No. 13, for further discussion about the unpredictability of auditing procedures.

[82] Auditing Standard No. 13 discusses the auditor's response to fraud risks and other significant risks.

mitigate specific risks of fraud, e.g., controls to address risks of intentional misstatement of specific accounts and (b) controls designed to prevent, deter, and detect fraud, e.g., controls to promote a culture of honesty and ethical behavior.[83] Such controls also include those that address the risk of management override of other controls.

Revision of Risk Assessment

74. The auditor's assessment of the risks of material misstatement, including fraud risks, should continue throughout the audit. When the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.[84]

APPENDIX A—Definitions

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

A2. Business risks—Risks that result from significant conditions, events, circumstances, actions, or inactions that could adversely affect a company's ability to achieve its objectives and execute its strategies. Business risks also might result from setting inappropriate objectives and strategies or from changes or complexity in the company's operations or management.

A3. Company's objectives and strategies—The overall plans for the company as established by management or the board of directors. Strategies are the approaches by which management intends to achieve its objectives.

A4. Risk assessment procedures—The procedures performed by the auditor to obtain information for identifying and assessing the risks of material misstatement in the financial statements whether due to error or fraud.

Note: Risk assessment procedures by themselves do not provide sufficient appropriate evidence on which to base an audit opinion.

A5. Significant risk—A risk of material misstatement that requires special audit consideration.

[83] AU sec. 316.88 and paragraph 14 of Auditing Standard No. 5 present examples of controls that address fraud risks.

[84] *See also* paragraph 46 of Auditing Standard No. 13.

APPENDIX B—Consideration of Manual and Automated Systems and Controls

B1. While obtaining an understanding of the company's information system related to financial reporting, the auditor should obtain an understanding of how the company uses information technology ("IT") and how IT affects the financial statements.[85] The auditor also should obtain an understanding of the extent of manual controls and automated controls used by the company, including the IT general controls that are important to the effective operation of the automated controls. That information should be taken into account in assessing the risks of material misstatement.[86]

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

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

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

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both;
- Unauthorized access to data that might result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions or inaccurate recording of transactions (particular risks might arise when multiple users access a common database);
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby breaking down segregation of duties;
- Unauthorized changes to data in master files;
- Unauthorized changes to systems or programs;
- Failure to make necessary changes to systems or programs;
- Inappropriate manual intervention; and
- Potential loss of data or inability to access data as required.

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

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

[85] *See also* AU sec. 324, *Service Organizations,* if the company uses a service organization for services that are part of the company's internal control over financial reporting.

[86] *See also* paragraphs 16–17 of Auditing Standard No. 9, *Audit Planning.*

Auditing Standard No. 13

The Auditor's Responses to the Risks of Material Misstatement

Introduction

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

Objective

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

Responding to the Risks of Material Misstatement

3. To meet the objective in the preceding paragraph, the auditor must design and implement audit responses that address the risks of material misstatement that are identified and assessed in accordance with Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

4. This standard discusses the following types of audit responses:

a. Responses that have an overall effect on how the audit is conducted ("overall responses"), as described in paragraphs 5–7; and

b. Responses involving the nature, timing, and extent of the audit procedures to be performed, as described in paragraphs 8–46.

Overall Responses

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

a. *Making appropriate assignments of significant engagement responsibilities.* The knowledge, skill, and ability of engagement team members with significant engagement responsibilities should be commensurate with the assessed risks of material misstatement.[87]

b. *Providing the extent of supervision that is appropriate for the circumstances, including, in particular, the assessed risks of material misstatement.* (See paragraphs 5–6 of Auditing Standard No. 10, *Supervision of the Audit Engagement.*)

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

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

(2) Varying the timing of the audit procedures;

(3) Selecting items for testing that have lower amounts or are otherwise outside customary selection parameters;

(4) Performing audit procedures on an unannounced basis; and

(5) In multi-location audits, varying the location or the nature, timing, and extent of audit procedures at related locations or business units from year to year.[88]

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,[89] 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 the auditor's judgments about the quality of a company's accounting principles.

6. The auditor also should determine whether it is necessary to make pervasive changes to the nature, timing, or extent of audit procedures to adequately address the assessed risks of material misstatement. Examples of such pervasive changes include modifying the audit strategy to:

a. Increase the substantive testing of the valuation of numerous significant accounts at year end because of significantly deteriorating market conditions, and

b. Obtain more persuasive audit evidence from substantive procedures due to the identification of pervasive weaknesses in the company's control environment.

7. Due professional care requires the auditor to exercise professional skepticism.[90] Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence. The auditor's responses to the assessed risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit evidence.[91] Examples of the application of professional skepticism in response to the assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters, such as through third-party confirmation, use of a specialist engaged or employed by the auditor, or examination of documentation from independent sources.

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

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

9. In designing the audit procedures to be performed, the auditor should:

a. Obtain more persuasive audit evidence the higher the auditor's assessment of risk;

b. Take into account the types of potential misstatements that could result from the identified risks and the likelihood and magnitude of potential misstatement;[92]

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[93] assessments for purposes of the audit of financial statements;[94] and

(2) To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end.

Note: Auditing Standard No. 5 establishes requirements for tests of controls in the audit of internal control over financial reporting.

10. The audit procedures performed in response to the assessed risks of material misstatement can be classified into two categories: (1) tests of controls and (2) substantive procedures.[95] Paragraphs 16–35 of this standard discuss tests of controls, and paragraphs 36–46 discuss substantive procedures.

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

Responses to Significant Risks

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

Note: Auditing Standard No. 12 discusses identification of significant risks[96] and states that fraud risks are significant risks.

Responses to Fraud Risks

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

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[87] *See also* paragraph .06 of AU sec. 230, *Due Professional Care in the Performance of Work.*

[88] For integrated audits, paragraphs 61 and B13 of Auditing Standard No. 5, *An audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* establish requirements for introducing unpredictability in testing of controls from year to year and in multi-location audits.

[89] Paragraphs 12–13 of Auditing Standard No. 12 discuss the auditor's responsibilities regarding obtaining an understanding of the company's selection and application of accounting principles. *See also* paragraphs .66–.67 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* and paragraphs .04 and .06 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.*

[90] AU secs. 230.07–.09.

[91] AU sec. 316.13.

[92] For example, potential misstatements regarding disclosures include omission of required disclosures or presentation of inaccurate or incomplete disclosures.

[93] *See* paragraph 7.b. of Auditing Standard No. 8, *Audit Risk,* for a definition of control risk.

[94] For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

[95] Substantive procedures consist of (a) tests of details of accounts and disclosures and (b) substantive analytical procedures.

[96] *See* paragraph 71 of Auditing Standard No. 12 for factors that the auditor should evaluate in determining which risks are significant risks.

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

Note: Auditing Standard No. 5 establishes requirements for addressing assessed fraud risks in the audit of internal control over financial reporting.[97]

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

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

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

b. Changing the *timing* of audit procedures to be closer to the end of the period or to the points during the period in which fraudulent transactions are more likely to occur; and

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. 316.54–.67 provide additional examples of responses to assessed fraud risks relating to fraudulent financial reporting (e.g., revenue recognition, inventory quantities, and management estimates) and misappropriation of assets in the audit of financial statements.

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

a. Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud (AU secs. 316.58–.62);

b. Reviewing accounting estimates for biases that could result in material misstatement due to fraud (AU secs. 316.63–.65); and

c. Evaluating the business rationale for significant unusual transactions (AU secs. 316.66–.67).

Testing Controls

Testing Controls in an Audit of Financial Statements

16. *Controls to be Tested.* If the auditor plans to assess control risk at less than the maximum by relying on controls,[98] 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**.[99] However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

17. Also, tests of controls must be performed in the audit of financial statements for each relevant assertion for which substantive procedures alone cannot provide sufficient appropriate audit evidence and when necessary to support the auditor's reliance on the accuracy and completeness of financial information used in performing other audit procedures.[100]

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

18. *Evidence about the Effectiveness of Controls in the Audit of Financial Statements.* In designing and performing tests of controls for the audit of financial statements, the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The auditor should obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. The auditor also should obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.

Testing Design Effectiveness

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

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

20. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.[101]

Testing Operating Effectiveness

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

22. Procedures the auditor performs to test operating effectiveness include a

[97] Paragraphs 14–15 of Auditing Standard No. 5.

[98] Reliance on controls that is supported by sufficient and appropriate audit evidence allows the auditor to assess control risk at less than the maximum, which results in a lower assessed risk of material misstatement. In turn, this allows the auditor to modify the nature, timing, and extent of planned substantive procedures.

[99] Terms defined in Appendix A, *Definitions,* are set in **boldface type** the first time they appear.

[100] Paragraph 10 of Auditing Standard No. 15, *Audit Evidence,* and paragraph .16 of AU sec. 329, *Substantive Analytical Procedures.*

[101] Paragraphs 37–38 of Auditing Standard No. 12 discuss performing a walkthrough.

mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Obtaining Evidence From Tests of Controls

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

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

Nature of Tests of Controls

24. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in the order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control.

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

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

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

Extent of Tests of Controls

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

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

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

Note: AU sec. 350, *Audit Sampling,* establishes requirements regarding the use of sampling in tests of controls.

Timing of Tests of Controls

28. The timing of tests of controls relates to when the evidence about the operating effectiveness of the controls is obtained and the period of time to which it applies. Paragraph 16 of this standard indicates that the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire period of reliance.

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

30. The additional evidence that is necessary to update the results of testing from an interim date through the remaining period of reliance depends on the following factors:

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

Note: If there have been significant changes to the control since the interim date, the auditor should obtain evidence about the effectiveness of the new or modified control;

- The inherent risk associated with the related account(s) or assertion(s);
- The specific control tested prior to year end, including the nature of the control and the risk that the control is no longer effective during the remaining period, and the results of the tests of the control;
- The planned degree of reliance on the control;
- The sufficiency of the evidence of effectiveness obtained at an interim date; and
- The length of the remaining period.

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

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) or assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of entity-level controls that the auditor has tested, especially controls that monitor other controls;
- The nature of the controls and the frequency with which they operate;
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;
- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); [102]
- The complexity of the control and the significance of the judgments that must be made in connection with its operation;

[102] The auditor also may use a benchmarking strategy, when appropriate, for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B28 of Auditing Standard No. 5.

- The planned degree of reliance on the control;
- 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; and
- For integrated audits, the evidence regarding the effectiveness of the controls obtained during the audit of internal control.

Assessing Control Risk

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

33. Control risk should be assessed at the maximum level for relevant assertions (1) for which controls necessary to sufficiently address the assessed risk of material misstatement in those assertions are missing or ineffective or (2) when the auditor has not obtained sufficient appropriate evidence to support a control risk assessment below the maximum level.

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

a. Perform tests of other controls related to the same assertion as the ineffective controls, or

b. Revise the control risk assessment and modify the planned substantive procedures as necessary in light of the increased assessment of risk.

Note: Auditing Standard No. 5 establishes requirements for 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,* establishes requirements for communicating significant deficiencies and material weaknesses in an audit of financial statements only.

Testing Controls in an Audit of Internal Control

35. Auditing Standard No. 5 states that the objective of the tests of controls in an audit of internal control is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a point in time and taken as a whole.[103] Auditing Standard No. 5 establishes requirements regarding the selection of controls to be tested and the necessary nature, timing, and extent of tests of controls in an audit of internal control over financial reporting.

Substantive Procedures

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

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

38. Internal control over financial reporting has inherent limitations,[104] which, in turn, can affect the evidence that is needed from substantive procedures. For example, more evidence from substantive procedures ordinarily is needed for relevant assertions that have a higher susceptibility to management override or to lapses in judgment or breakdowns resulting from human failures.[105]

Nature of Substantive Procedures

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

Note: Auditing Standard No. 15 discusses certain types of substantive procedures and the relevance and reliability of audit evidence.

[103] Paragraph B1 of Auditing Standard No. 5.

[104] Paragraph A5 of Auditing Standard No. 5.

[105] *See, e.g.,* paragraph .14 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures.*

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

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

a. Reconciling the financial statements with the underlying accounting records; and

b. Examining material adjustments made during the course of preparing the financial statements.

Note: AU secs. 316.58–.62 establish requirements for examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.

Extent of Substantive Procedures

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

Timing of Substantive Procedures

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

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

a. The assessed risk of material misstatement, including:

(1) The auditor's assessment of control risk, as discussed in paragraphs 32–34;

(2) The existence of conditions or circumstances, if any, that create incentives or pressures on management to misstate the financial statements between the interim test date and the end of the period covered by the financial statements;

(3) The effects of known or expected changes in the company, its environment, or its internal control over financial reporting during the remaining period;

b. The nature of the substantive procedures;

c. The nature of the account or disclosure and relevant assertion; and

d. The ability of the auditor to perform the necessary audit procedures to cover the remaining period.

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

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

Dual-Purpose Tests

47. In some situations, the auditor might perform a substantive test of a transaction concurrently with a test of a control relevant to that transaction (a "**dual-purpose test**"). In those situations, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested.[106]

APPENDIX A—Definitions

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

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

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

Auditing Standard No. 14

Evaluating Audit Results

Introduction

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

Objective

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

Evaluating the Results of the Audit of Financial Statements

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

4. In the audit of financial statements,[107] the auditor's evaluation of audit results should include evaluation of the following:

a. The results of analytical procedures performed in the overall review of the financial statements ("overall review");

b. **Misstatements** accumulated during the audit, including, in particular, **uncorrected misstatements;**[108]

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 the disclosures; and

f. The sufficiency and appropriateness of the audit evidence obtained.

Performing Analytical Procedures in the Overall Review

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

6. As part of the overall review, the auditor should evaluate whether:

a. The evidence gathered in response to unusual or unexpected transactions, events, amounts, or relationships previously identified during the audit is sufficient; and

b. Unusual or unexpected transactions, events, amounts, or relationships[109] indicate risks of material misstatement that were not identified previously, including, in particular, fraud risks.

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

7. The nature and extent of the analytical procedures performed during the overall review may be similar to the analytical procedures performed as risk assessment procedures. The auditor should perform analytical procedures relating to revenue through the end of the reporting period.[110]

8. The auditor should obtain corroboration for management's explanations regarding significant unusual or unexpected transactions,

[106] Paragraph .44 of AU sec. 350 discusses applying audit sampling in dual-purpose tests.

[107] For purposes of this standard, the term "audit of financial statements" refers to the financial statement portion of the integrated audit and to the audit of financial statements only.

[108] Terms defined in Appendix A, *Definitions,* are set in **boldface type** the first time they appear.

[109] Paragraphs 46–48 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* and paragraph .03 of AU sec. 329, *Substantive Analytical Procedures.*

[110] Paragraph 47 of Auditing Standard No. 12 contains a requirement to perform analytical procedures relating to revenue as part of the risk assessment procedures.

events, amounts, or relationships. If management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures to address the matter.

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

Accumulating and Evaluating Identified Misstatements

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

Note: "Clearly trivial" is not another expression for "not material." Matters that are clearly trivial will be of a smaller order of magnitude than the materiality level established in accordance with Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit,* and will be inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature, or circumstances. When there is any uncertainty about whether one or more items is clearly trivial, the matter is not considered trivial.

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

12. The auditor's accumulation of misstatements should include the auditor's best estimate of the total misstatement in the accounts and disclosures that he or she has tested, not just the amount of misstatements specifically identified. This includes misstatements related to accounting estimates, as determined in accordance with paragraph 13 of this standard, and projected misstatements from substantive procedures that involve audit sampling, as determined in accordance with AU sec. 350, *Audit Sampling.*[111]

13. *Misstatements Relating to Accounting Estimates.* If the auditor concludes that the amount of an accounting estimate included in the financial statements is unreasonable or was not determined in conformity with the relevant requirements of the applicable financial reporting framework, he or she should treat the difference between that estimate and a reasonable estimate determined in conformity with the applicable accounting principles as a misstatement. If a range of reasonable estimates is supported by sufficient appropriate audit evidence and the recorded estimate is outside of the range of reasonable estimates, the auditor should treat the difference between the recorded accounting estimate and the closest reasonable estimate as a misstatement.

Note: If an accounting estimate is determined in conformity with the relevant requirements of the applicable financial reporting framework 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. Paragraph 27 discusses evaluating accounting estimates for bias.

14. *Considerations as the Audit Progresses.* The auditor should determine whether the overall audit strategy and audit plan need to be modified 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 or levels used in planning and performing the audit.[112]

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

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

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

17. *Evaluation of the Effect of Uncorrected Misstatements.* The auditor should evaluate whether uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the specific accounts and disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.[113] (See Appendix B.)

Note: In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the * * * fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[114] 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 * * *."[115]

Note: As a result of the interaction of quantitative and qualitative considerations in materiality judgments, uncorrected misstatements of relatively small amounts could have a material effect on the financial statements. For

[111] AU sec. 350.26.

[112] Auditing Standard No. 11.

[113] If the financial statements contain material misstatements, AU sec. 508, *Reports on Audited Financial Statements,* indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

[114] *TSC Industries* v. *Northway, Inc.,* 426 U.S. 438, 449 (1976). *See also Basic, Inc.* v. *Levinson,* 485 U.S. 224 (1988).

[115] *TSC Industries,* 426 U.S. at 450.

example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility [116] that it could lead to a material contingent liability or a material loss of revenue.[117] Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

Note: If the reevaluation of the established materiality level or levels, as set forth in Auditing Standard No. 11,[118] results in a lower amount for the materiality level or levels, the auditor should take into account that lower materiality level or levels in the evaluation of uncorrected misstatements.

18. The auditor's evaluation of uncorrected misstatements, as described in paragraph 17 of this standard, should include evaluation of the effects of uncorrected misstatements detected in prior years and misstatements detected in the current year that relate to prior years.

19. The auditor cannot assume that an instance of error or fraud is an isolated occurrence. Therefore, the auditor should evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement. This evaluation is important in determining whether the risk assessments remain appropriate, as discussed in paragraph 36 of this standard.

20. *Evaluating Whether Misstatements Might Be Indicative of Fraud.* The auditor should evaluate whether identified misstatements [119] 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 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.[120]

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

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

23. If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, he or she also must determine his or her responsibilities under AU secs. 316.79–.82A, AU sec. 317, 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

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

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

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

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

b. The identification by management of additional adjusting entries that offset misstatements accumulated by the auditor. If such adjusting entries are identified, the auditor should perform procedures to determine why the underlying misstatements were not identified previously and evaluate the implications on the integrity of management and the auditor's risk assessments, including fraud risk assessments. The auditor also should perform additional procedures as necessary to address the risk of further undetected misstatement.

c. Bias in the selection and application of accounting principles.[121]

d. Bias in accounting estimates.[122]

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

27. *Evaluating Bias in Accounting Estimates.* The auditor should evaluate whether the difference between estimates best supported by the audit evidence and estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the company's management. If each accounting estimate included in the financial statements was individually reasonable but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase earnings or loss, the auditor should evaluate whether these circumstances indicate potential management bias in the estimates. Bias also can result from the cumulative effect of changes in multiple accounting estimates. If the estimates in the financial statements are grouped at one end of the range of reasonable estimates in the prior year and are grouped at the other end of the range of reasonable estimates in the current year, the auditor should evaluate whether management is using swings in estimates to achieve an expected or desired outcome, e.g., to offset higher or lower than expected earnings.

[116] There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450–20–25–1.

[117] AU sec. 317, *Illegal Acts by Clients.*

[118] Paragraphs 11–12 of Auditing Standard No. 11.

[119] Misstatements include omission and presentation of inaccurate or incomplete disclosures.

[120] AU sec. 316.05.

[121] Paragraph 5.d. of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

[122] Paragraph 27 of this standard.

Note: AU secs. 316.64–.65 establish requirements regarding performing a retrospective review of accounting estimates and evaluating the potential for fraud risks.

Evaluating Conditions Relating to the Assessment of Fraud Risks

28. When evaluating the results of the audit, the auditor should evaluate whether the accumulated results of auditing procedures [123] and other observations affect the assessment of the fraud risks made throughout the audit and whether the audit procedures need to be modified to respond to those risks. (See Appendix C.)

29. As part of this evaluation, the engagement partner should determine whether there has been appropriate communication with the other engagement team members throughout the audit regarding information or conditions that are indicative of fraud risks.

Note: To accomplish this communication, the engagement partner might arrange another discussion among the engagement team members about fraud risks. (See paragraphs 49–51 of Auditing Standard No. 12.)

Evaluating the Presentation of the Financial Statements, Including the Disclosures

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

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

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

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

Note: According to AU sec. 508, if the financial statements, including the accompanying notes, fail to disclose information that is required by the applicable financial reporting framework, the auditor should express a qualified or adverse opinion and should provide the information in the report, if practicable, unless its omission from the report is recognized as appropriate by a specific auditing standard.[124]

Evaluating the Sufficiency and Appropriateness of Audit Evidence

32. Auditing Standard No. 8, *Audit Risk,* states:

To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.[125]

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

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

a. The 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 14 and 17–19 of this standard).

b. The results of audit procedures performed in the audit of financial statements, including whether the evidence obtained supports or contradicts management's assertions and whether such audit procedures identified specific instances of fraud (paragraphs 20–23 and 28–29 of this standard).

c. The auditor's risk assessments (paragraph 36 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.

e. The appropriateness (i.e., the relevance and reliability) of the audit evidence obtained.[126]

35. If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion or has substantial doubt about a relevant assertion, the auditor should perform procedures to obtain further audit evidence to address the matter. If the auditor is unable to obtain sufficient appropriate audit evidence to have a reasonable basis to conclude about whether the financial statements as a whole are free of material misstatement, AU sec. 508 indicates that the auditor should express a qualified opinion or a disclaimer of opinion.[127]

36. *Evaluating the Appropriateness of Risk Assessments.* As part of the evaluation of whether sufficient appropriate audit evidence has been obtained, the auditor should evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate and whether the audit procedures need to be modified or additional procedures need to be performed as a result of any changes in the risk assessments. For example, the re-evaluation 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: Auditing Standard No. 12 establishes requirements on revising the auditor's risk assessment.[128] Auditing Standard No. 13 discusses the auditor's responsibilities regarding the assessment of control risk and evaluation of control deficiencies in an audit of financial statements.[129]

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

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

[123] Such auditing procedures include, but are not limited to, procedures in the overall review (paragraph 9 of this standard), the evaluation of identified misstatements (paragraphs 20–23 of this standard), and the evaluation of the qualitative aspects of the company's accounting practices (paragraphs 24–27 of this standard).

[124] AU secs. 508.41–.44.

[125] Paragraph 3 of Auditing Standard No. 8.

[126] Paragraphs 7–9 of Auditing Standard No. 15, *Audit Evidence,* discuss the relevance and reliability of audit evidence.

[127] AU sec. 508.22–.34 contains requirements regarding audit scope limitations.

[128] Paragraph 74 of Auditing Standard No. 12.

[129] Paragraphs 32–34 of Auditing Standard No. 13.

that the auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls, misstatements detected during the financial statement audit, and any identified control deficiencies. Auditing Standard No. 5 describes the auditor's responsibilities regarding evaluating the results of the audit, including evaluating the identified control deficiencies.[130]

APPENDIX A—Definitions

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

A2. Misstatement—A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework.[131] A misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework. Misstatements can arise from error (i.e., unintentional misstatement) or fraud.[132]

A3. Uncorrected misstatements—Misstatements, other than those that are clearly trivial,[133] that management has not corrected.

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

B1. Paragraph 17 of this standard states: The auditor should evaluate whether uncorrected misstatements are material, individually or in combination with other misstatements. In making this evaluation, the auditor should evaluate the misstatements in relation to the specific accounts and disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.[134]

Note: In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the * * * fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[135] 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 * * *"[136]

Note: As a result of the interaction of quantitative and qualitative considerations in materiality judgments, uncorrected misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility[137] that it could lead to a material contingent liability or a material loss of revenue.[138] Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.

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

a. The potential effect of the misstatement on trends, especially trends in profitability.

b. A misstatement that changes a loss into income or vice versa.

c. The effect of the misstatement on segment information, for example, the significance of the matter to a particular segment important to the future profitability of the company, the pervasiveness of the matter on the segment information, and the impact of the matter on trends in segment information, all in relation to the financial statements taken as a whole.

d. The potential effect of the misstatement on the company's compliance with loan covenants, other contractual agreements, and regulatory provisions.

e. The existence of statutory or regulatory reporting requirements that affect materiality thresholds.

f. A misstatement that has the effect of increasing management's compensation, for example, by satisfying the requirements for the award of bonuses or other forms of incentive compensation.

g. The sensitivity of the circumstances surrounding the misstatement, for example, the implications of misstatements involving fraud and possible illegal acts, violations of contractual provisions, and conflicts of interest.

h. The significance of the financial statement element affected by the misstatement, for example, a misstatement affecting recurring earnings as contrasted to one involving a non-recurring charge or credit, such as an extraordinary item.

i. The effects of misclassifications, for example, misclassification between operating and non-operating income or recurring and non-recurring income items.

j. The significance of the misstatement or disclosures relative to known user needs, for example:

- The significance of earnings and earnings per share to public company investors.
- The magnifying effects of a misstatement on the calculation of purchase price in a transfer of interests (buy/sell agreement).
- The effect of misstatements of earnings when contrasted with expectations.

k. The definitive character of the misstatement, for example, the precision of an error that is objectively determinable as contrasted with a misstatement that unavoidably involves a degree of subjectivity through estimation, allocation, or uncertainty.

l. The motivation of management with respect to the misstatement, for example, (i) an indication of a possible pattern of bias by management when developing and accumulating accounting estimates or (ii) a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process.

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[130] 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.

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

[132] Paragraph .02 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*

[133] Paragraph 10 of this standard states that, "[t]he auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial."

[134] If the financial statements contain material misstatements, AU sec. 508, *Reports on Audited Financial Statements,* indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

[135] *TSC Industries v. Northway, Inc.,* 426 U.S. 438, 449 (1976). *See also Basic, Inc.* v. *Levinson,* 485 U.S. 224 (1988).

[136] *TSC Industries,* 426 U.S. at 450.

[137] There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450–20–25–1.

[138] AU sec. 317, *Illegal Acts by Clients.*

m. The existence of offsetting effects of individually significant but different misstatements.

n. The likelihood that a misstatement that is currently immaterial may have a material effect in future periods because of a cumulative effect, for example, that builds over several periods.

o. The cost of making the correction—it may not be cost-beneficial for the client to develop a system to calculate a basis to record the effect of an immaterial misstatement. On the other hand, if management appears to have developed a system to calculate an amount that represents an immaterial misstatement, it may reflect a motivation of management as noted in paragraph B2.l above.

p. The risk that possible additional undetected misstatements would affect the auditor's evaluation.

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

C1. If the following matters are identified during the audit, the auditor should take into account these matters in the evaluation of the assessment of fraud risks, as discussed in paragraph 28 of this standard:

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.[139]

(3) Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.

(4) Significant unexplained items in 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 responses.

(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, e.g., receivables growing faster than revenues.

(11) Large numbers of credit entries and other adjustments made to accounts receivable records.

(12) Unexplained or inadequately explained differences between the accounts receivable subsidiary ledger and the general ledger control account, or between the customer statement and the accounts receivable subsidiary ledger.

(13) Missing or nonexistent 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:[140]

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 information technology 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 pressure on 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) Management's unwillingness to add or revise disclosures in the financial statements to make them more complete and transparent.

(6) Management's unwillingness to appropriately address significant deficiencies in internal control on a timely basis.

d. Other matters, including:

(1) Objections by management to the auditor meeting 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) Tolerance of violations of the company's code of conduct.

Auditing Standard No. 15

Audit Evidence

Introduction

1. This standard explains what constitutes audit evidence and establishes requirements 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 auditor's 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 information that contradicts such assertions.

Objective

3. The objective of the auditor is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report.[141]

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[139] Paragraph 9 of Auditing Standard No. 15, *Audit Evidence.*

[140] 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.*)

[141] Auditing Standard No. 14, *Evaluating Audit Results,* establishes requirements regarding evaluating whether sufficient appropriate evidence has been obtained. Auditing Standard No. 3, *Audit Documentation,* establishes requirements regarding documenting the procedures performed, evidence obtained, and conclusions reached in an audit.

Sufficient Appropriate Audit Evidence

4. The auditor must plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion.

5. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the following:

• *Risk of material misstatement (in the audit of financial statements) or the risk associated with the control (in the audit of internal control over financial reporting).* As the risk increases, the amount of evidence that the auditor should obtain also increases. For example, ordinarily more evidence is needed to respond to significant risks.[142]

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

6. Appropriateness is the measure of the quality of audit evidence, i.e., its relevance and reliability. To be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based.

Relevance and Reliability

7. *Relevance.* The relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The relevance of audit evidence depends on:

a. The design of the audit procedure used to test the assertion or control, in particular whether it is designed to (1) test the assertion or control directly and (2) test for understatement or overstatement; and

b. The timing of the audit procedure used to test the assertion or control.

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

• Evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources.

• The reliability of information generated internally by the company is increased when the company's controls over that information are effective.

• Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly.

• Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized, or otherwise converted into electronic form, the reliability of which depends on the controls over the conversion and maintenance of those documents.

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

Using Information Produced by the Company

10. When using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to:[143]

• Test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and

• Evaluate whether the information is sufficiently precise and detailed for purposes of the audit.

Financial Statement Assertions

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

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

• *Completeness*—All transactions and accounts that should be presented in the financial statements are so included.

• *Valuation or allocation*—Asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts.

• *Rights and obligations*—The company holds or controls rights to the assets, and liabilities are obligations of the company at a given date.

• *Presentation and disclosure*—The components of the financial statements are properly classified, described, and disclosed.

12. The auditor may base his or her work on financial statement assertions that differ from those in this standard if the assertions are sufficient for the auditor to identify the types of potential misstatements and to respond appropriately to the risks of material misstatement in each significant account and disclosure that has a reasonable possibility[144] of containing misstatements that would cause the financial statements to be materially misstated, individually or in combination with other misstatements.[145]

Audit Procedures for Obtaining Audit Evidence

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

a. Risk assessment procedures,[146] and

b. Further audit procedures,[147] which consist of:

(1) Tests of controls, and

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

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

Inspection

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

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[142] Paragraph A5 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

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

[144] There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450–20–25–1.

[145] For an integrated audit, also *see* paragraph 28 of Auditing Standard No. 5.

[146] Auditing Standard No. 12.

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

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 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.[148]

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.[149]

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

Confirmation

18. A confirmation response represents a particular form of audit evidence obtained by the auditor from a third party in accordance with PCAOB standards.[150]

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 nonfinancial data. Analytical procedures also encompass the investigation of significant differences from expected amounts.[151]

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 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; and
- 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 in 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 items in an account or the entire population of occurrences of a control (or an entire stratum within one of those populations). 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; and
- The audit procedure can be automated effectively and applied to the entire population.

Selecting Specific Items

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

- *Key items.* The auditor may decide to select specific items within a population because they are important to accomplishing the objective of the audit procedure or exhibit some other characteristic, e.g., items that are suspicious, unusual, or particularly risk-prone or items 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 25–26 of this standard does not constitute audit sampling, and the results of those audit procedures cannot be projected to the entire population.[152]

Audit Sampling

28. Audit sampling is the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.[153]

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

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

Conforming Amendment to PCAOB Interim Quality Control Standards

Auditing Standards

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

Statement on Auditing Standards ("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"), as amended, 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 Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit.*

AU sec. 150, "Generally Accepted Auditing Standards"

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[148] AU sec. 331, *Inventories,* establishes requirements regarding observation of the counting of inventory.

[149] AU sec. 333, *Management Representations,* establishes requirements regarding written management representations, including confirmation of management responses to oral inquiries.

[150] AU sec. 330, *The Confirmation Process.*

[151] AU sec. 329, *Substantive Analytical Procedures,* establishes requirements on performing analytical procedures as substantive procedures.

[152] If misstatements are identified in the selected items, *see* paragraphs 12–13 and paragraphs 17–19 of Auditing Standard No. 14.

[153] AU sec. 350, *Audit Sampling,* establishes requirements regarding audit sampling.

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

a. Within paragraph .02, in the third standard of field work, the word "competent" is replaced with the word "appropriate."

b. Footnote 2 to paragraph .04 is deleted.

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

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

The last sentence of paragraph .03 is replaced with: The engagement partner must exercise seasoned judgment in the varying degrees of his supervision and review of the work done and judgments exercised by his subordinates, who in turn must meet the responsibilities attaching to the varying gradations and functions of their work.

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

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

a. The second and third sentences of paragraph .06 are replaced with: The engagement partner should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client. The engagement partner is responsible for the assignment of tasks to, and supervision of, the members of the engagement team.[fn4]

b. Footnote 3 to paragraph .06 is deleted.

c. Within footnote 4 to paragraph .06, the phrase "See section 311.11" is replaced with, "See Auditing Standard No. 10, *Supervision of the Audit Engagement*."

d. Footnote 6 to paragraph .11 is deleted.

e. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

f. At the end of the fifth sentence of paragraph .12, the following parenthetical is added: "(See paragraph 9 of Auditing Standard No. 15, *Audit Evidence*.)"

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

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

a. Within footnote ** to the title of the standard, the sentence "(See section 313.)" is deleted.

b. Paragraph .02 is replaced with: Audit planning is discussed in Auditing Standard No. 9, *Audit Planning,* and supervision of engagement team members is discussed in Auditing Standard No. 10, *Supervision of the Audit Engagement.*

c. In paragraph .03, the sentence "(See section 313)" is deleted.

d. Within footnote 3 to paragraph .06, the reference to Section 312, *Audit Risk and Materiality in Conducting an Audit,* paragraph .04, is replaced with a reference to Paragraph A2 of Auditing Standard No. 14, *Evaluating Audit Results.*

AU sec. 311, "*Planning and Supervision*"

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

a. The second sentence of paragraph .01 is replaced with: This section establishes requirements and provides direction relevant to fulfilling that responsibility, as it relates to fraud, in an audit of financial statements.[fn2]

b. In footnote 1 to paragraph .01, delete the following information: (see section 312, *Audit Risk and Materiality in Conducting an Audit,*" and the closing parenthesis at the end of that sentence.

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 financial statements only.

d. The following paragraph .01A is added: Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements. Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement,* establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement. Auditing Standard No. 14, *Evaluating Audit Results,* establishes requirements regarding the auditor's evaluation of audit results and determination of whether he or she has obtained sufficient appropriate audit evidence.

e. In paragraph .02:

- The third through the sixth bullet points are deleted.
- The seventh bullet point is replaced with: *Responding to fraud risks*

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

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

- The eighth bullet point is deleted.

f. Paragraph .03 is deleted.

g. Footnote 5 to paragraph .06 is replaced with: The auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to accounting principles applicable to that company.

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

i. Paragraphs .14 through .45 are deleted, along with the preceding heading, "Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud."

j. Footnotes 8 through 19 related to paragraphs .14 through .45 are deleted.

k. Paragraphs .46 through .50 are deleted. The heading preceding paragraph .46, "Responding to the Results of the Assessment," is replaced with the heading "Responding to Assessed Fraud Risks."

l. Paragraph .51 is deleted. The heading preceding paragraph .51, "Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed to Address the Identified Risks," is replaced with the heading "Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed."

m. Paragraph .52 is replaced with: Paragraph 8 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement,* states that "[t]he auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement due to error or fraud for each relevant assertion of each significant account and disclosure." Paragraph 12 of Auditing Standard No. 13 states that "the audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected."

Note: Paragraph 71.b. of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* states that a fraud risk is a significant risk. Accordingly, the requirement for responding to significant risks also applies to fraud risks.

n. In paragraph .53:

- The first sentence is replaced with: The following are examples of responses to assessed fraud risks involving the nature, timing, and extent of audit procedures:
- The fifth bullet point is replaced with: Interviewing personnel involved in activities in areas in which a fraud risk has been identified to obtain their insights about the risk and how controls address the risk. (See paragraph 54 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*)
- In the sixth bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

o. Footnote 20 to paragraph .53 is replaced with: AU sec. 329, *Substantive Analytical Procedures,* establishes requirements regarding performing analytical procedures as substantive tests.

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

q. The first sentence in paragraph .54 is replaced with: The following are additional examples of audit procedures that might be performed in response to assessed fraud risks relating to fraudulent financial reporting:

r. In paragraph .54:

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

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

- The text of footnote 21 is replaced with "AU sec. 330, *The Confirmation Process,* establishes requirements regarding the confirmation process in audits of financial statements."
- The text of footnote 22 is replaced with "AU sec. 336, *Using the Work of a Specialist,* establishes requirements for an auditor who uses the work of a specialist in performing an audit of financial statements."

t. The heading preceding paragraph .55, "Examples of Responses to Identified Risks of Misstatements Arising From Misappropriations of Assets," is replaced with the heading "Examples of Audit Procedures Performed to Respond to Fraud Risks Relating to Misappropriations of Assets."

u. In the first sentence of paragraph .55, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."

v. In paragraph .56:

- The first and second sentences are replaced with: The audit procedures performed in response to a fraud risk relating to misappropriation of assets usually will be directed toward certain account balances. Although some of the audit procedures noted in paragraphs .53 and .54 and in paragraphs 8 through 15 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement,* may apply in such circumstances, such as the procedures directed at inventory quantities, the scope of the work should be linked to the specific information about the misappropriation risk that has been identified.
- In the third sentence, the words "design and" are added before the words "operating effectiveness."

w. The heading preceding paragraph .57, "Responses to Further Address the Risk of Management Override of Controls," is replaced with the heading "Audit Procedures Performed to Specifically Address the Risk of Management Override of Controls."

x. The third sentence of paragraph .57 is replaced with: Accordingly, as part of the auditor's responses that address fraud risks, the procedures described in paragraphs .58 through .67 should be performed to specifically address the risk of management override of controls.

y. Footnote 23 to paragraph .58 is replaced with: See paragraphs 28 through 32 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

z. In paragraph .61:

- In the first sentence of the first bullet point, the term "the risk of material misstatement due to fraud" is replaced with the term "fraud risk."
- In the second bullet point, the last two sentences are replaced with the following: Effective controls over the preparation and posting of journal entries and adjustments may affect the extent of substantive testing necessary, provided that the auditor has tested the controls. However, even though controls might be implemented and operating effectively, the auditor's substantive procedures for testing journal entries and other adjustments should include the identification and substantive testing of specific items.
- In item (f) of the fifth bullet point, the term "risk of material misstatement due to fraud" is replaced with the term "fraud risk."
- The last sentence of the fifth bullet point is replaced with: In audits of entities that have multiple locations or business units, the auditor should determine whether to select journal entries from locations based on factors set forth in paragraphs 11 through 14 of

Auditing Standard No. 9, *Audit Planning.*

aa. The last sentence of paragraph .63 is replaced with: Paragraphs 24 through 27 of Auditing Standard No. 14, *Evaluating Audit Results,* discuss the auditor's responsibilities for assessing bias in accounting estimates and the effect of bias on the financial statements.

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

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

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

ee. The last sentence of paragraph .80 is replaced with: The auditor also should evaluate whether the absence of or deficiencies in controls that address fraud risks or otherwise help prevent, deter, and detect fraud (see paragraphs 72–73 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*) represent significant deficiencies or material weaknesses that should be communicated to senior management and the audit committee.

ff. The first sentence of paragraph .81 is replaced with: The auditor also should consider communicating other fraud risks, if any, identified by the auditor.

gg. In paragraph .83:

• The reference in the first bullet point to paragraphs .14 through .17 is replaced with a reference to paragraphs 52 and 53 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

• The term "risks of material misstatement due to fraud" in the first sentence of the second bullet point is replaced with the term "fraud risks." The reference in the second bullet point to paragraphs .19 through .34 is replaced with references to paragraph 47, paragraphs 56 through 58, and paragraphs 65 through 69 of Auditing Standard No. 12, *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 59 through 69 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*), and the linkage of those risks to the auditor's response (see paragraphs 5 through 15 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*).

• Within the fourth bullet point, the term "risk of material misstatement due to fraud" in the first sentence is replaced with the term "fraud risk," and the reference to paragraph .41 is replaced with a reference to paragraph 68 of Auditing Standard No. 12, *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 procedures performed to further address the risk of management override of controls (See paragraph 15 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatements.*)

• The reference in the sixth bullet point to paragraphs .68 through .73 is replaced with a reference to paragraphs 5 through 9 of Auditing Standard No. 14, *Evaluating Audit Results.*

hh. Paragraph .84 and the heading preceding this paragraph, "Effective Date," are deleted.

ii. The first sentence of paragraph .85 is replaced with: This appendix contains examples of risk factors discussed in paragraphs 65 through 69 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

AU sec. 317, "*Illegal Acts by Clients*"

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

a. The last sentence of paragraph .13 is replaced with: For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

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

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

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

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

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

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

b. Footnote 3 to paragraph .04, is replaced with: Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* describes the procedures the auditor performs to obtain an understanding of internal control over financial reporting.

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 section 326, *Evidential Matter,* paragraph .19c. is replaced with a reference to paragraph 8 of Auditing Standard No. 15, *Audit Evidence.*

e. Within footnote 8 to paragraph .27, the reference to section 311, *Planning and Supervision,* paragraphs .11 through .14 is replaced with a reference to Auditing Standard No. 10, *Supervision of the Audit Engagement.*

AU sec. 324, "*Service Organizations*"

SAS No. 70, "Service Organizations" (AU sec. 324, "Service Organizations"), 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 Auditing Standard No. 12, *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 paragraph 18 and paragraphs 29 through 31 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

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 Auditing Standard No. 14, *Evaluating Audit Results.*

AU sec. 326, "*Evidential Matter*"

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

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

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

a. Paragraphs .01–.05 are deleted, along with the preceding heading "1. Evidential Matter for an Audit of Interim Financial Statements."

b. The reference in paragraph .10 to Section 326, *Evidential Matter,* paragraph .25, is replaced with a reference to Paragraph 35 of Auditing Standard No. 14, *Evaluating Audit Results.*

c. In the first and second sentences of paragraph .10, the word "competent" is replaced with the word "appropriate."

d. In the second sentence of paragraph .12, the word "competent" is replaced with the word "appropriate."

e. The last two sentences of paragraph .12 are deleted.

f. In the first sentence of paragraph .13, the word "competent" is replaced with the word "appropriate."

g. In paragraph .17, the word "competent" is replaced with the word "appropriate."

h. In the second sentence of paragraph .21, the word "competent" is replaced with the word "appropriate."

i. In the fourth sentence of paragraph .22, the word "competent" is replaced with the word "appropriate."

j. In paragraph .23, the word "competent" is replaced with the word "appropriate."

k. Paragraphs .24–.41 are deleted, along with the headings "3. The Auditor's Consideration of the Completeness Assertion" and "4. Applying Auditing Procedures to Segment Disclosures in Financial Statements."

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

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

a. In the first sentence of paragraph .03, the word "competent" is replaced with the word "appropriate."

b. The phrase in paragraph .11 "Section 319, *Consideration of Internal Control in a Financial Statement Audit,* as amended," is replaced with "Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,*"

c. The reference in paragraph .14 to Section 319 is replaced with a reference to Paragraph A5, second note of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

d. In the second sentence of paragraph .14, the reference "(see section 316, *Consideration of Fraud in a Financial Statement Audit*" is deleted.

e. Within paragraph .25, in the second sentence of the second bullet point and in the first sentence in the third bullet point, the word "competent" is replaced with the word "appropriate."

f. In the second sentence of paragraph .32, the word "competent" is replaced with the word "appropriate."

g. In the first sentence of paragraph .42, the word "competent" is replaced with the word "appropriate."

h. In footnote 8 to paragraph .43, the reference to section 431, *Adequacy of Disclosure in Financial Statements,* is replaced with a reference to "paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.*"

i. In the second sentence of paragraph .44, the word "competent" is replaced with the word "appropriate."

j. 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 paragraphs 12 through 18 and 24 through 27 of Auditing Standard No. 14, *Evaluating Audit Results.*

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 the title, "Substantive Analytical Procedures."

b. The text of paragraph .01 is replaced with: This section establishes requirements regarding the use of substantive analytical procedures in an audit.

Note: Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* establishes requirements regarding performing analytical procedures as a risk assessment procedure in identifying and assessing risks of material misstatement.

Note: Auditing Standard No. 14, *Evaluating Audit Results,* establishes requirements regarding performing analytical procedures as part of the overall review stage of the audit.

c. The last sentence of paragraph .03 is deleted.

d. The text of paragraph .04 is replaced with: Analytical procedures are used as a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions. In some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

e. Paragraphs .06–.08 and the preceding heading, "Analytical Procedures in Planning the Audit," are deleted.

f. At the end of paragraph .09, the following new sentence is added: (See paragraph 11 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*)

g. Within footnote 1 to paragraph .09, the reference to section 326, *Evidential Matter,* is replaced with a reference to Auditing Standard No. 15, *Audit Evidence.*

h. Footnote 2 to paragraph .20 is deleted.

i. In paragraph .21:

• In the fourth sentence, the word "likely" is deleted.

• The reference to section 316, *Consideration of Fraud in a Financial Statement Audit,* is replaced with a reference to Auditing Standard No. 14, *Evaluating Audit Results.*

j. Footnote 3 to paragraph .21 is deleted.

k. Paragraph .23 and the preceding heading, "Analytical Procedures Used in the Overall Review," and paragraph .24 and the preceding heading, "Effective Date," 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 Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

b. The reference in paragraph .05 to Section 312 is replaced with a reference to Auditing Standard No. 8, *Audit Risk.*

c. The second sentence of paragraph .06 is replaced with: See paragraph 8 of Auditing Standard No. 15, *Audit Evidence,* which discusses the reliability of audit evidence.

d. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

e. In the third sentence of paragraph .11, the reference to Section 326 is replaced with a reference to Auditing Standard No. 15, *Audit Evidence.*

f. In the first sentence of paragraph .24, the word "competence" is replaced with the word "appropriateness."

g. 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 paragraphs 11 and 12 of Auditing Standard No. 15, *Audit Evidence.*

b. Paragraph .06 is replaced with: Auditing Standard No. 9, *Audit Planning,* discusses the auditor's responsibilities for consideration of the use of persons with specialized skill or knowledge. Auditing Standard No. 10, *Supervision of the Audit Engagement,* discusses the auditor's responsibilities for supervision of specialists who are employed by the auditor. AU sec. 336, *Using the Work of a Specialist,* discusses the auditor's responsibilities for using the work of a specialist engaged by the auditor.

c. The first and second sentences of paragraph .07 are deleted. The third sentence is replaced with:

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

d. The reference in paragraph .09 to Section 319, *Consideration of Internal Control in a Financial Statement Audit,* is replaced with a reference to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

e. The fourth sentence of paragraph .11 is replaced with "Paragraphs 28 through 32 and B1 through B6 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* discuss the information system, including related business processes, relevant to financial reporting."

f. In paragraph .15, the reference to section 319 is replaced with a reference to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

g. The last sentence of paragraph .35 is replaced with: In addition, paragraphs 24 through 27 of Auditing Standard No. 14, *Evaluating Audit Results,* describe the auditor's responsibilities for assessing bias in accounting estimates.

h. In paragraph .43, subparagraph a., the word "competent" is replaced with the word "appropriate."

i. In paragraph .51, the last sentence is replaced with: (See paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.*)

j. In paragraph .57, subparagraph 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: Auditing Standard No. 14, *Evaluating Audit Results,* indicates that a misstatement can arise from error or fraud and also 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 Paragraph 11 of Auditing Standard No. 14, *Evaluating Audit Results.*

c. Within footnote 7 to paragraph .06, the reference to section 316, *Consideration of Fraud in a Financial Statement Audit,* paragraphs .38 through .40, is replaced with a reference to section 316, *Consideration of Fraud in a Financial Statement Audit,* paragraphs .79 through .82.

AU sec. 334, "Related Parties"

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

a. In the second sentence of paragraph .09, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

c. In footnote 8 to paragraph .11, the reference to section 431, *Adequacy of Disclosure in Financial Statements,* is replaced with a reference to paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.*

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

AU sec. 9334, "Related Parties: Auditing Interpretations of Section 334," is amended as follows: Within footnote 4 to paragraph .17, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit,* is replaced with a reference to Auditing Standard No. 8, *Audit Risk.*

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

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

a. Footnote 1 to paragraph .01 is replaced with the following: Because income taxes and information technology are specialized areas of accounting and auditing, this section does not apply to situations in which an income tax specialist or information technology specialist participates in the audit. Auditing Standard No. 10, *Supervision of the Audit Engagement,* applies in those situations.

b. Paragraph .05 is replaced with the following: This section does not apply to situations in which a specialist employed by the auditor's firm participates in the audit. Auditing Standard No. 10, *Supervision of the Audit Engagement,* applies in those situations.

c. In the last sentence of paragraph .06, the word "competent" is replaced with the word "appropriate."

d. In the first and last sentences of paragraph .13, the word "competent" is replaced with the word "appropriate."

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

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

a. In the second sentence of paragraph .04, the word "competent" is replaced with the word "appropriate."

b. In paragraph .05, the word "competent" is replaced with the word "appropriate."

c. In the second sentence of paragraph .11, the word "competent" is replaced with the word "appropriate."

d. The penultimate sentence of paragraph .15, is replaced with: Paragraph 6 of Auditing Standard No. 15, *Audit Evidence,* states, "[t]o be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based."

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 Auditing Standard No. 15, *Audit Evidence.*

AU sec. 342, "Auditing Accounting Estimates"

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

a. In the first sentence of paragraph .01, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph .07, the word "competent" is replaced with the word "appropriate."

c. The text of footnote 3 to paragraph .07 is replaced with: See paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.*

d. The reference in paragraph .08 subparagraph b.1. to section 311, *Planning and Supervision,* is replaced with a reference to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

e. Paragraph .14, is replaced with: Paragraphs 24 through 27 of Auditing Standard No. 14, *Evaluating Audit Results,* discuss the auditor's responsibilities for assessing bias and evaluating accounting estimates in relationship to the financial statements taken as a whole.

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

AU sec. 9342, "Auditing Accounting Estimates: Auditing Interpretations of Section 342," is amended as follows: In the second sentence of paragraph .02, the word "competent" is replaced with the word "appropriate."

AU sec. 350, "Audit Sampling"

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

a. Within footnote 2 to paragraph .02, the reference to section 312, *Audit Risk and Materiality in Conducting an Audit,* is replaced with a reference to Auditing Standard No. 14, *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. In paragraph .06:

- The first sentence is deleted.
- In the last sentence, the word "competence" is replaced with the word "appropriateness."
- The following note is added to the paragraph:

Note: Auditing Standard No. 15, *Audit Evidence,* discusses the appropriateness of audit evidence, and Auditing Standard No. 14, *Evaluating Audit Results,* discusses the auditor's responsibilities for evaluating the sufficiency and appropriateness of audit evidence.

e. Paragraph .08 is deleted.

f. In paragraph .09:

- The sentence in paragraph .09 referring to section 313, which is in parentheses, is deleted.
- The following note is added to the paragraph:

Note: Auditing Standard No. 8, *Audit Risk,* describes audit risk and its components in a financial statement audit—the risk of material misstatement (consisting of inherent risk and control risk) and detection risk.

g. In paragraph .11:

- The phrase "(see section 311, *Planning and Supervision*)" is deleted.
- The sentence "(See section 313.)" is deleted.

h. The second sentence of paragraph .15 is replaced with: See Auditing Standard No. 9, *Audit Planning.*

i. In the first bullet in paragraph .16, the phrase "(see section 326, *Evidential Matter*)" is deleted.

j. In the second bullet of paragraph .16, the phrase "Preliminary judgments about materiality levels" is replaced with the phrase "Tolerable misstatement. (See paragraphs .18–18A.)"

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 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 account balance or class of transactions is called *tolerable misstatement.*

l. Paragraph .18A is added: Paragraphs 8–9 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit,* describe the auditor's responsibilities for determining tolerable misstatement at the account or disclosure level. When the population to be sampled constitutes a portion of an account balance or transaction class, the auditor should determine tolerable misstatement for the population to be sampled for purposes of designing the sampling plan. Tolerable misstatement for the population to be sampled ordinarily should be less than tolerable misstatement for the account balance or transaction class to allow for the possibility that misstatement in the portion of the account or transaction class not subject to audit sampling, individually or in combination with other misstatements, would cause the financial statements to be materially misstated.

m. Paragraph .20 is deleted.

n. 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.

o. Paragraph .23 is replaced with: To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account tolerable misstatement for the population; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected size and frequency of misstatements.

p. Paragraph .23A is added: Table 1 of the Appendix describes the effects of the factors discussed in the preceding paragraph on sample sizes in a statistical or nonstatistical sampling approach. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or nonstatistical approach is used. Thus, when a nonstatistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

q. 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 (a) implications in relation to his or her risk assessments (including the assessment of fraud risk), (b) implications regarding the integrity of management or employees, and (c) possible effects on other aspects of the audit.

r. Footnote 6 to paragraph .26 is replaced with: Paragraphs 10 through 23 of Auditing Standard No. 14, *Evaluating Audit Results,* discuss the auditor's consideration of differences between the accounting records and the underlying facts and circumstances.

s. Within footnote 7 to paragraph .32, the phrase "(see 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.

t. The last sentence of paragraph .38 is replaced with: 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.

u. The fifth sentence of paragraph .39 is replaced with: Paragraphs 44 through 46 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement,* describe the auditor's responsibilities for performing procedures between the interim date of testing and period end.

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

w. 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 as 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.

• The fifth sentence is replaced with: In evaluating such tests, deviations from the control that was tested and monetary misstatements should be evaluated separately using the risk levels applicable for the respective purposes.

• The following Note is added to the paragraph:

Note: Paragraph 47 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement,* provides additional discussion of the auditor's responsibilities for performing dual-purpose tests.

x. The reference in paragraph .45 to paragraph .04 is changed to a reference to paragraph .03.

y. In item 2 of paragraph .48, the last sentence is deleted.

z. Within footnote 1 to item 4 in paragraph .48, the sentence "(See section 313.)" is deleted.

aa. The sentence in item 6 of paragraph .48 "(See section 313.)" is deleted.

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

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

AU sec. 380, "*Communication With Audit Committees*"

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

In footnote 5 to paragraph .10, the reference to section 316A.38–.40 is replaced with a reference to AU secs. 316.79–.82; the reference to section 316A is replaced with a reference to section 316.

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

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

a. In paragraph .04, the reference in (c) to section 431 is replaced with a reference to paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results;* in (d), the reference to section 431 is replaced with a reference to paragraph 31 of Auditing Standard No. 14.

b. The reference in footnote 1 to paragraph .04 to 312.10 is replaced with a reference to Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit.*

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

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

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

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

a. In paragraph 18C, the phrase "and in AU sec. 431" is deleted.

b. In subparagraph .20.a., the word "competent" is replaced with the word "appropriate."

c. In the second sentence of paragraph .22, the word "competent" is replaced with the word "appropriate."

d. In the third sentence of paragraph .24, the word "competent" is replaced with the word "appropriate."

e. In footnote 15 to paragraph .38, the first sentence is replaced with:

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

f. The references in paragraph .49 to section 312, *Audit Risk and Materiality,* and to section 342, *Auditing Accounting Estimates,* are replaced with a reference to paragraph 13 of Auditing Standard No. 14, *Evaluating Audit Results.*

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

h. In paragraph .66, the second sentence is replaced with:

(See paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.*)

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

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

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

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

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

a. In the first sentence of paragraph .01, the word "competent" is replaced with the word "appropriate."

b. In the second note to paragraph .01, the word "competent" is replaced with the word "appropriate."

c. In the first sentence of paragraph .05, the word "competent" is replaced with the word "appropriate."

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

SAS No. 1, "Codification of Auditing Standards and Procedures," section 543 "Part of Audit Performed by Other Independent Auditors" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), as amended, is amended as follows:

a. The following note is added as the second note to paragraph .01:

Note: For situations in which the auditor engages an accounting firm or individual accountants to participate in the audit engagement and AU sec. 543 does not apply, the auditor should supervise them in accordance with the requirements of Auditing Standard No. 10, *Supervision of the Audit Engagement.*

b. Within paragraph .12:

• Subparagraph b. is replaced with: A list of significant risks, the auditor's responses, and the results of the auditor's related procedures.

• Subparagraph f. is replaced with: A schedule of accumulated misstatements, including a description of the nature and cause of each accumulated misstatement, and an evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

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

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

a. *Paragraph .16 is replaced with: Interpretation*—The principal auditor's response should ordinarily be made by the engagement partner. The engagement partner should take those steps that he or she considers reasonable under the circumstances to be informed of known matters pertinent to the other auditor's inquiry. For example, the engagement partner may inquire of engagement team members responsible for various aspects of the engagement or he or she may direct engagement team members to bring to his or her attention any significant matters of which they become aware during the audit. The principal auditor is not required to perform any procedures directed toward identifying matters that would not affect his or her audit or his or her report.

b. Footnote 4 to paragraph .16 is deleted.

AU sec. 722, "*Interim Financial Information*"

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

a. Within footnote 7 to paragraph .11, the first sentence is replaced with: Paragraphs 10 through 23 of Auditing Standard No. 14, *Evaluating Audit Results,* 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 Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

c. Within the last sentence of paragraph .16, the title of section 329, "Analytical Procedures," is replaced with the title "Substantive Analytical Procedures."

d. Footnote 20 to paragraph .26 is deleted.

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

Auditing Standard No. 3, Audit Documentation

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

a. Within paragraph 3, subparagraph b. is replaced with: Supervisory personnel who review documentation prepared by other members of the engagement team.

b. Paragraph 9A is added: Documentation of risk assessment procedures and responses to risks of misstatement should include (1) a summary of the identified risks of misstatement and the auditor's assessment of risks of material misstatement at the financial statement and assertion levels and (2) the auditor's responses to the risks of material misstatement, including linkage of the responses to those risks.

c. Within paragraph 12:

• Within subparagraph a.:, (1) a footnote reference 2A is added at the end of the first sentence: See paragraphs 12–13 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* and paragraphs .66–.67 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.* and (2) the second sentence of subparagraph a. is deleted.

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

• Subparagraph c. is replaced with: Accumulated misstatements and evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

• Footnote 2B is added to subparagraph c.: See paragraphs 10–23 of Auditing Standard No. 14, *Evaluating Audit Results.*

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

• Subparagraph f. is replaced with: Significant changes in the auditor's risk assessments, including risks that were not identified previously, and the modifications to audit procedures or additional audit procedures performed in response to those changes.

• Footnote 2C is added to subparagraph f.: See paragraph 74 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* and paragraph 36 of Auditing Standard No. 14, *Evaluating Audit Results.*

• Subparagraph f–1. is added: Risks of material misstatement that are determined to be significant risks and the results of the auditing procedures performed in response to those risks.

d. Within paragraph 19:

• Subparagraph b. is replaced with: A list of significant risks, the auditor's responses, and the results of the auditor's related procedures.

• Subparagraph f. is replaced with: A schedule of accumulated misstatements, including a description of the nature and cause of each accumulated misstatement, and an evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.

e. Paragraph 21 and the preceding heading, "Effective Date," are deleted.

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

Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist,* as amended, is amended as follows: In the first sentence of paragraph 18, the word "competent" is replaced with the word "appropriate."

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

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

a. In the second sentence of paragraph 3, the word "competent" is replaced with the word "appropriate."

b. In the first sentence of paragraph 9, the phrase "any assistants" is replaced with the phrase "the engagement team members."

c. Within footnote 10 to paragraph 14, the reference to paragraphs .19–.42 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* is replaced with a reference to Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

d. The reference in paragraph 15 to AU sec. 316.44 and .45 is replaced with a reference to paragraphs 65–69 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

e. Within footnote 11 to paragraph 20, the reference to AU sec. 312, *Audit Risk and Materiality in Conducting an Audit,* is replaced with a reference to Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit.*

f. Within footnote 12 to paragraph 28, the reference to AU sec. 326, *Evidential Matter,* is replaced with a reference to Auditing Standard No. 15, *Audit Evidence.*

g. Within footnote 13 to the note to paragraph 31, the reference to AU sec. 312.39 is replaced with a reference to paragraph 14 of Auditing Standard No. 14, *Evaluating Auditing Results.* The reference to AU sec. 316.50 is replaced with a reference to paragraph 5 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

h. The references in paragraph 36 to paragraphs .16–.20, .30–.32, and .77–.79 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit,* are replaced with references to paragraph 29 and

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

i. In the first sentence of paragraph 51, the word "competent" is replaced with the word "appropriate."

j. In the first sentence of paragraph 89, the word "competent" is replaced with the word "appropriate."

k. Within the note to paragraph C6 in Appendix C, the word "competent" is replaced with the word "appropriate."

Auditing Standard No. 6, Evaluating Consistency of Financial Statements

Auditing Standard No. 6, *Evaluating Consistency of Financial Statements,* is amended as follows:

a. Footnote 3 to paragraph 4 is deleted.

b. In paragraph 10, the reference to AU sec. 431, *Adequacy of Disclosure in Financial Statements,* is replaced with a reference to paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.*

Auditing Standard No. 7, Engagement Quality Review

Auditing Standard No. 7, *Engagement Quality Review,* is amended as follows:

a. Footnote 3 to paragraph 5 is replaced with: The term "engagement partner" has the same meaning as the "practitioner-in-charge of an engagement" in PCAOB interim quality control standard QC sec. 40, *The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement.* QC sec. 40 describes the competencies required of a practitioner-in-charge of an attest engagement.

b. In paragraph 10, the note following subparagraph b. is replaced with: Note: A *significant risk* is a risk of material misstatement that requires special audit consideration.

Ethics Standards

ET sec. 102, "*Integrity and Objectivity*"

ET sec. 102, "Integrity and Objectivity," is amended as follows: Footnote 1 to paragraph .05 is replaced with: See paragraph 5.b. of Auditing Standard No. 10, *Supervision of the Audit Engagement,* and paragraph 12.d. of Auditing Standard No. 3, *Audit Documentation.*

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rules and discussed any comments it received on the proposed rules. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

(a) Purpose

Section 103(a) of the Act directs the Board, by rule, to establish, among other things, "auditing and related attestation standards * * * to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by th[e] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." As discussed more fully in Exhibit 3, the Board adopted eight auditing standards and related amendments that benefit investors by establishing requirements that enhance the effectiveness of the auditor's assessment of and response to the risks of material misstatement in an audit.

In an audit performed in accordance with PCAOB standards, risk underlies the entire audit process, including the procedures that the auditor performs to support the opinion expressed in the auditor's report. Most of the Board's interim auditing standards relating to assessing and responding to risk in an audit of financial statements were developed in the 1980s.[154] Those standards described in general terms the auditor's responsibilities for assessing and responding to risk. They directed auditors to vary the amount of audit attention related to particular financial statement accounts based on the risks presented by them. The standards also allowed the auditor to use tests of controls to reduce substantive testing.[155]

A number of factors and events led the Board to reexamine those standards and seek to improve them. These included the widespread use of risk-based audit methodologies; recommendations to the profession on ways in which auditors could improve risk assessment;[156] advice from the Board's Standing Advisory Group ("SAG");[157] 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.

On October 21, 2008, the Board proposed a set of auditing standards to update the requirements for assessing and responding to risk in an audit ("the original proposed standards").[158] The original proposed standards were intended to improve the auditing standards and to benefit investors by establishing requirements that enhance the effectiveness of auditors' assessment of and response to risk through:

- Performing procedures that provide a reasonable basis for identifying and assessing risks of material misstatement, whether due to error or fraud
- Tailoring the audit to respond appropriately to the risks of material misstatement
- Making a comprehensive evaluation of the evidence obtained during the audit to form the opinion(s) in the auditor's report

The Board also sought to emphasize the auditor's responsibilities for consideration of fraud by incorporating requirements for identifying and responding to the risks of material misstatement due to fraud ("fraud risks") and evaluating audit results from the existing PCAOB standard, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*[159] Incorporating these requirements makes clear that the auditor's responsibilities for assessing and responding to fraud risks are an integral part of the audit process rather than a separate, parallel process. It also benefits investors by prompting auditors to make a more thoughtful and thorough assessment of fraud risks and to develop appropriate audit responses.

Improvements in the standards related to risk assessment also should enhance integration of the audit of financial statements with the audit of internal control over financial reporting ("audit of internal control") by articulating a process for identifying and assessing risks of material misstatement that applies to both portions of the

[154] Examples of those standards include AU sec. 312, *Audit Risk and Materiality in Conducting an Audit,* and AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit.*

[155] AU sec. 319.

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

[157] Webcasts of SAG meetings are available on the Board's Web site at: *http://www.pcaobus.org/News_and_Events/Webcasts.*

[158] PCAOB Release No. 2008–006, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (October 21, 2008).

[159] Paragraphs .14–.51 and paragraphs .68–.78 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*

integrated audit when the auditor is performing an integrated audit.

The proposed rules also amend the Board's interim standards including superseding the following sections of PCAOB interim auditing standards:

- AU sec. 311, *Planning and Supervision*
- AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*
- AU sec. 313, *Substantive Tests Prior to the Balance Sheet Date*
- AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*
- AU sec. 326, *Evidential Matter*
- AU sec. 431, *Adequacy of Disclosure in Financial Statements*

Similarly, the auditing interpretations of AU secs. 311, 312, and 350 have been incorporated into the risk assessment standards and thus are superseded. The auditing interpretations of AU sec. 326, except for Interpretation No. 2 (AU secs. 9326.06-.23), also are superseded.[160]

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

B. Board's Statement on Burden on Competition

The Board does not believe that the proposed rule changes will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rule changes would apply equally to all registered public accounting firms conducting audits in accordance with PCAOB standards.

C. Board's Statement on Comments on the Proposed Rules Received From Members, Participants or Others

The Board released the proposed rules for public comment in PCAOB Release No. 2008–006 (October 21, 2008). The Board received 33 written comments. The Board considered these comments and made changes to the initial proposed rules. As a result, the Board again sought public comment in PCOAB Release No. 2009–007 (December 21, 2009). The Board received 23 written comment letters relating to its reproposal of the proposed rules. A copy of PCAOB Release Nos. 2008–006 and 2009–007 and the comment letters received in response to the PCAOB's request for comment in both releases are available on the PCAOB's Web site at *http://www.pcaobus.org.*

The Board has carefully considered all comments it has received. In response to the written comments received on both the initial and reproposal of the proposed rules, the Board has clarified and modified certain aspects of the proposed rules, as discussed below.

Overview of the Risk Assessment Standards

Many commenters on the original proposed standards were supportive of the Board's efforts to update its risk assessment requirements and offered numerous suggestions for changing the original proposed standards. After considering all of the comments received on those standards, the Board made numerous refinements to the original proposed standards. Because the standards address many fundamental aspects of the audit process and are expected to serve as a foundation for future standards-setting, the Board reproposed the standards for public comment on December 17, 2009 ("the reproposed standards").[161]

The Board received 23 comment letters on the reproposed standards.[162] The Board discussed the comments received with the SAG on April 8, 2010.[163] Most commenters were generally supportive of the reproposed standards and the improvements made to those standards. Many commenters also offered suggestions to improve the standards, which the Board has carefully analyzed.

After consideration of the comments received, the Board has refined the standards to provide additional clarity. The Board has decided to adopt the following standards for assessing and responding to risk in an audit and the related amendments to PCAOB standards:

- Auditing Standard No. 8, *Audit Risk*
- Auditing Standard No. 9, *Audit Planning*
- Auditing Standard No. 10, *Supervision of the Audit Engagement*
- Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*
- Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*
- Auditing Standard No. 14, *Evaluating Audit Results*
- Auditing Standard No. 15, *Audit Evidence*

1. Notable Areas of Change in the Standards

The changes made to the reproposed standards reflect refinements rather than significant shifts in approach. This section describes the areas of change to the reproposed standards that are most notable, *e.g.,* because they affect multiple standards or multiple sections of an individual standard. This Release discusses these and other changes in more detail.

a. Planning and Supervision Standards

The reproposed standards included a standard covering both audit planning and supervision. Some commenters observed that audit planning and supervision should be covered in separate standards.

Audit planning and supervision, although related in some respects, are distinct activities that should be presented in separate standards. Accordingly, the Board has divided the planning and supervision standard into separate standards for planning and for supervision. Presenting the requirements for planning and supervision in separate standards is a technical change that, by itself, does not affect the auditor's responsibilities for planning the audit or supervision of the work of engagement team members as described in the reproposed standards.

b. Requirements for Multi-Location Audits

The reproposed standard on audit planning and supervision included requirements regarding establishing the scope of testing of individual locations in multi-location engagements. The reproposed standard on consideration of materiality in planning and performing an audit included requirements for determining materiality of individual locations in multi-location audits. Some commenters requested clarification on the Board's expectations regarding how to apply those requirements in audits in which part of the work is performed by other auditors, specifically, auditors of financial statements of individual locations or business units that are included in the consolidated financial statements.

The multi-location requirements have been revised to take into account situations in which part of the work is

[160] Interpretation No. 2 relates in part to AU sec. 336 and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments,* and it will be evaluated in connection with standards-setting projects related to those standards.

[161] PCAOB Release No. 2009–007, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (December 17, 2009).

[162] Comments on the original proposed standards and the reproposed standards are available on the Board's Web site at: *http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx.*

[163] A transcript of the portion of the meeting that related to the reproposed standards is available on the Board's Web site at: http://www.pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx.

performed by other auditors.[164] This release discusses those revisions in more detail and explains the Board's expectations regarding how to apply the respective requirements in situations involving other auditors.

The reproposed standard on audit planning and supervision also included a statement, similar to a statement in Auditing Standard No. 5, that "The direction in paragraph 5 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement,* regarding incorporating an element of unpredictability in the auditing procedures means that the auditor should vary the nature, timing, and extent of audit procedures at locations or business units from year to year." Some commenters stated that the statement in the reproposed audit planning and supervision standard was unnecessarily prescriptive. After considering the comments received, the requirement regarding unpredictability was removed from the audit planning standard, and the discussion in Auditing Standard No. 13 regarding incorporating an element of unpredictability was expanded to include varying the testing in the selected locations.[165] However, this does not change the requirements in Auditing Standard No. 5 regarding incorporating unpredictability in testing controls at individual locations in audits of internal control.[166]

c. Requirement for Performing Walkthroughs

In the original proposed standards, the standard on identifying and assessing risks of material misstatement referred auditors to Auditing Standard No. 5 for a discussion of the performance of walkthroughs. Some commenters on the original proposed standards stated that the proposed standard should include a discussion of walkthroughs rather than referring to Auditing Standard No. 5. The reproposed standard on identifying and assessing risks of material misstatement included a discussion of the objectives for understanding likely sources of potential misstatements and of performing walkthroughs, which paralleled a discussion in Auditing Standard No. 5.[167] Some commenters expressed concerns that those new requirements would lead to unnecessary walkthroughs, particularly in audits of financial statements only.

The intention of including the discussion of walkthroughs was to describe how to perform walkthroughs, not to impose additional requirements regarding when to perform walkthroughs. The discussion has been revised to focus on how the auditor should perform walkthroughs, and the discussion of the objectives for understanding likely sources of potential misstatements has been removed.[168] Consequently, the objectives in paragraph 34 of Auditing Standard No. 5 for understanding potential sources of likely misstatement will continue to apply only to integrated audits.

d. Requirements Regarding Financial Statement Disclosures

Because of the importance of disclosures to the fair presentation of financial statements and based on observations from the Board's oversight activities, the reproposed standards included additional requirements intended to increase the auditor's attention on the disclosures in the financial statements. For example, the reproposed standard on identifying and assessing risks of material misstatement included a new requirement related to developing an expectation about the necessary financial statement disclosures as part of obtaining an understanding of the company and its environment. Some commenters stated that the requirements should be clarified as applying to disclosures required by the applicable financial reporting framework. Also, the reproposed standard on evaluating audit results included expanded requirements for the auditor to evaluate whether the financial statements include the required disclosures. Some commenters stated that the standard should clarify that the requirements apply only to material disclosures.

After analyzing the comments, those two requirements have been revised to clarify that they refer to the fair presentation of the financial statements in conformity with the applicable financial reporting framework.[169]

2. Discussion of Comments That Relate to Many of the Reproposed Standards

The following paragraphs discuss matters raised by commenters that relate to many of the reproposed standards. Section II.C.13 of this release contains a discussion of other topics raised by commenters on matters other than the risk assessment standards or the related amendments.

a. Consideration of Fraud in the Audit

Section I of the Board's adopting release discusses the Board's objectives regarding incorporating into its risk assessment standards the requirements for identifying and responding to risks of material misstatement due to fraud ("fraud risks") and evaluating audit results from AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*[170]

The number of comments received on this approach to incorporate the requirements from AU sec. 316 declined significantly from the original proposed standards.[171] The views of commenters continue to be mixed. One commenter supported the approach, and two commenters expressed concerns about the approach.

The risk assessment standards continue to include relevant requirements from AU sec. 316. The Board has observed from its oversight activities instances in which auditors have performed the procedures required in AU sec. 316 mechanically, without using the procedures to develop insights on fraud risk or to modify the audit plan to address that risk. The Board also has observed instances in which firms have failed to respond appropriately to identified fraud risks.

These observations suggest that some auditors may improperly view the consideration of fraud as an isolated, mechanical process rather than an integral part of audits under PCAOB standards. Integrating the requirements from AU sec. 316 into the risk assessment standards emphasizes to auditors that assessing and responding to fraud risks is an integral part of an audit in accordance with PCAOB standards, rather than a separate consideration. Such integration also should prompt auditors to make a more thoughtful and thorough assessment of the risks affecting the financial

[164] Paragraphs 11–14 of Auditing Standard No. 9, *Audit Planning,* and paragraph 10 of Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit.*

[165] Paragraph 5 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

[166] Paragraphs 61 and B13 of Auditing Standard No. 5.

[167] Paragraph 34 of Auditing Standard No. 5.

[168] Paragraphs 37–38 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

[169] Paragraph 13 of Auditing Standard No. 12 and paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results.*

[170] The risk assessment standards incorporate paragraphs .14–.51 and .68–.78 of AU sec. 316. Accordingly, those paragraphs are removed from AU sec. 316 by means of a related amendment.

[171] As discussed in Section I, the risk assessment standards were originally proposed on October 21, 2008. *See* PCAOB Release No. 2008–006, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk.*

statements, including fraud risks, and to develop appropriate audit responses. Furthermore, AU sec. 316, as amended, will continue to provide relevant information on determining the necessary procedures for considering fraud in a financial statement audit. (See section II.C.11.F.(ii). of this release for more discussion about AU sec. 316.)

b. Organization and Style of Standards (Including the Use of Notes and Appendices)

In response to comments on the original proposed standards, the Board presented the reproposed standards using an organization and style that is intended to be a template for future standards of the Board. The organization and style includes an objective for each standard, which provides additional context for understanding the requirements in the standard, and a separate appendix for definitions of terms used in each standard.

Commenters generally supported the organization and style of the reproposed standards, and some commenters suggested that existing PCAOB standards be revised to implement this organization and style. As stated in the release accompanying the reproposed standards, the organization and style used in the reproposed standards draws from previously issued standards of the Board, *e.g.,* Auditing Standard No. 7, *Engagement Quality Review.* Also, the Board will apply this template in the course of its other standards-setting activities.

Commenters expressed concerns about including requirements in appendices and notes to the standard. Consistent with standards previously issued by the Board, the notes and appendices in the risk assessment standards are integral parts of the standards and carry the same authoritative weight as the other portions of the standards.

c. Use of Terms

PCAOB Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards,* sets forth the terminology that the Board uses to describe the degree of responsibility that the auditing and related professional practice standards impose on auditors. The original proposed standards used terms in the requirements in a manner that was consistent with Rule 3101.

Some comments received on the original proposed standards suggested revisions to the terms used in the requirements or asked for clarification about certain terms or phrases, e.g., "take into account." The reproposed standards reflected numerous revisions to the terms used in the standards, and the risk assessment standards reflect further refinements. For example, the standards use "should consider" only when referring to a requirement to consider performing an action or procedure, which is consistent with Rule 3101.

As explained in the release accompanying the reproposed standards, the phrase "take into account" has been used previously in PCAOB standards in reference to information or matters that the auditor should think about or give attention to in performing an audit procedure or reaching a conclusion.[172] Accordingly, the results of the auditor's thinking on the relevant matters should be reflected in the performance and documentation of the respective audit procedure performed or conclusion reached. The accompanying standards continue to use "take into account" in the same way.

Some commenters asked about the meaning of certain terms, e.g., "assess," "evaluate," or "determine." Those commenters also stated that the Board should use those terms consistently throughout its standards. The Board has reviewed the use of each of those terms and has revised the standards as necessary to apply those terms more consistently. Subsequent sections of this release discuss specific revisions to the individual standards.

One commenter expressed concerns about statements that involve the use of present tense in the reproposed standards. As with standards that the Board previously issued, the present tense is used in the risk assessment standards for statements that are factual or definitional, e.g., to provide additional explanation of a required auditing procedure.[173] Subsequent sections of this release discuss specific instances of the use of present tense in the risk assessment standards.

d. Requirements and the Application of Judgment

Some commenters on the original proposed standards stated that the original proposed standards contained requirements that were "too prescriptive," limiting the auditor's ability to "use professional judgment or scale the audit," *e.g.,* because of the number of requirements in the standards and because the standards did not explicitly refer to professional judgment in the requirements. In the release accompanying the reproposed standards, the Board discussed the importance of professional judgment in fulfilling the requirements of the standards. After examining each requirement, the Board revised certain provisions in the reproposed standards to streamline the presentation of those requirements.

Although the Board received fewer comments on the reproposed standard related to this topic, two commenters continue to express concerns about whether the reproposed standards made adequate allowance for the auditor to use professional judgment in assessing and responding to risk in an audit.

PCAOB standards recognize that the auditor uses judgment in planning and performing audit procedures and evaluating the evidence obtained from those procedures.[174] As under other PCAOB standards, auditors need to exercise judgment in fulfilling the requirements of the risk assessment standards in the particular circumstances. Making references to judgment in selected portions of the standards, however, could be misinterpreted as indicating that judgment is required only in certain aspects of the audit. Instead of referring to judgment selectively, the risk assessment standards set forth principles for meeting the requirements of the standards and allow the auditor to determine the most appropriate way to comply with the requirements in the circumstances.

3. Auditing Standard No. 8—Audit Risk

a. Background

Auditing Standard No. 8 discusses audit risk and the relationships among the various components of audit risk in an audit of financial statements. The standard applies to integrated audits and to audits of financial statements only.

b. Objective

The reproposed standard stated that the objective of the auditor is to conduct the audit of financial statements in a manner that reduces audit risk to an appropriately low level. This objective provided important context for understanding how the concept of audit risk is applied in an audit.

One commenter observed that the reproposed standards sometimes used the phrase, "appropriately low level" and occasionally used the phrase "acceptably low level," and that

[172] AU sec. 316.45 and paragraphs 14, 44, 59, and B 12 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

[173] *See, e.g.,* paragraph 21 of Auditing Standard No. 5 for an example of the use of the present tense for this purpose.

[174] *See, e.g.,* paragraph .11 of AU sec. 230, *Due Professional Care in the Performance of Work.*

commenter suggested revising the standards to use "acceptably low level" in each instance. The Board continues to believe the term "appropriately low level" is more suitable because it is aligned more closely with the degree of assurance described in the auditor's opinion, *i.e.,* the auditor conducts the audit to reduce audit risk to an appropriately low level in order to express an opinion with reasonable assurance. In contrast, the term "acceptably low" is less clear and could be misinterpreted. The risk assessment standards have been revised to use the phrase "appropriately low level," as applicable.

c. Due Professional Care and Sufficient Appropriate Audit Evidence

The reproposed standard stated that, to form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. It also stated that reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.[175]

A commenter suggested that due professional care is a responsibility throughout the audit, similar to professional skepticism and judgment, and need not be repeated throughout the Board's standards. The Board agrees that due professional care is a responsibility throughout the audit. On the other hand, existing PCAOB standards state that due professional care allows the auditor to obtain reasonable assurance,[176] and the statement in Auditing Standard No. 8 acknowledges that principle.

d. Audit Risk and Risk of Material Misstatement

Some commenters on the original proposed standard requested more explanation about risks at the overall financial statement level, *e.g.,* by providing examples of such risks. The reproposed standard elaborated further on risks at the financial statement level.[177]

Commenters on the reproposed standard asked for more explanation regarding how financial statement level risks can result in material misstatement of the financial statements. The examples of financial statement level risks in Auditing Standard No. 8 have been expanded to illustrate how those risks can result in material misstatement of the financial statements.[178]

Some individual commenters offered suggestions for refining or clarifying the discussion of the risk of material misstatement and its components. For example, one commenter suggested that the description of the risk of material misstatement should state that the risk exists "prior to the audit" to more clearly indicate that it is the company's risk. The Board agrees that the risk of material misstatement exists irrespective of the audit, while the risk of not detecting material misstatement is the auditor's risk. However, the suggested phrase could be misinterpreted, *e.g.,* as implying that the auditor need not consider the risk of misstatements occurring during the audit.

The reproposed standard included a statement that inherent risk and control risk are the company's risks; they exist independently of the audit. One commenter suggested that the statement was not informative and suggested revising the standard to state that inherent risk and control risk are functions of the company's characteristics, but influence the auditor's actions. The Board agrees that more discussion of the auditor's consideration of inherent risk and control risk is appropriate. Thus, Auditing Standard No. 8 has been expanded to discuss the sources of evidence the auditor uses when assessing inherent risk and control risk.[179] Also, the description of control risk in Auditing Standard No. 8 has been aligned with the discussion of internal control concepts in Auditing Standard No. 5.

One commenter expressed a concern that descriptions of inherent risk, control risk, and detection risk that included the phrase "that could be material, individually or in combination with other misstatements," may be misinterpreted by the auditor as a requirement to consider whether the combination of dissimilar risks will result in a material misstatement. The commenter suggested changing "combination" to "aggregate." However, the standard does not discuss the combination of risks but, rather, the risk of a misstatement that could be material, individually or in combination with other misstatements, which is consistent with the description of the auditor's evaluation of uncorrected misstatements in Auditing Standard No. 14, *Evaluating Audit Results.* Thus, the term "combination" was retained as proposed.

e. Detection Risk

The reproposed standard indicated that detection risk is reduced by performing substantive procedures. Some commenters stated that the discussion of detection risk should be modified to indicate that auditors can reduce detection risk through procedures other than substantive procedures (*e.g.,* risk assessment procedures and tests of controls). A commenter also suggested changing the sentence in the standard to refer to "audit procedures" instead of "substantive procedures."

The Board acknowledges that auditors might obtain evidence of misstatements through procedures other than substantive procedures. However, that does not diminish the auditor's responsibility to plan and perform substantive procedures for significant accounts and disclosures that are sufficient to provide reasonable assurance of detecting misstatements that would result in material misstatement of the financial statements. Changing "substantive procedures" to "audit procedures," as suggested by the commenter, is not consistent with AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit,* and could be misunderstood by auditors, resulting in inadequate substantive procedures.[180] To provide further clarification, Auditing Standard No. 8 has been revised to describe the role of risk assessment procedures and tests of controls in assessing the risk of material misstatement, which, in turn, affects the appropriate level of detection risk.[181]

Some commenters expressed concerns that the reproposed standard did not adequately link the concepts of inherent risk and control risk to detection risk. They stated that a discussion on the relationship of these concepts is necessary for the auditor to determine the acceptable level of detection risk for the financial statement assertions, which, in turn, is used to determine the nature, timing, and extent of substantive procedures. The following discussion, which is adapted from AU sec. 319, was added to paragraph 10 of Auditing

[175] Paragraph 3 of Auditing Standard No. 8.

[176] AU sec. 230.10.

[177] Paragraph 6 of Auditing Standard No. 8.

[178] Ibid.

[179] Paragraph 8 of Auditing Standard No. 8.

[180] AU secs. 319.81–.82. AU sec. 319, along with 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. 326, *Evidential Matter,* and AU sec. 431, *Adequacy of Disclosure in Financial Statements,* are superseded by the risk assessment standards.

[181] Paragraphs 8–9 of Auditing Standard No. 8.

Standard No. 8: "The auditor uses the assessed risk of material misstatement to determine the appropriate level of detection risk for a financial statement assertion. The higher the risk of material misstatement, the lower the level of detection risk needs to be in order to reduce audit risk to an appropriately low level." [182]

f. Integrated Audit Considerations

Auditing Standard No. 8 applies both to audits of financial statements only and to the financial statement audit portion of integrated audits. Audit risk in the audit of financial statements relates to whether the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, while audit risk in an audit of internal control over financial reporting ("audit of internal control") relates to whether the auditor expresses an inappropriate audit opinion when one or more material weaknesses exist. The two forms of audit risk are related, however, and Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* indicates that the risk assessment procedures apply to both the audit of financial statements and the audit of internal control.

Some commenters suggested revisions to the first paragraph and the first footnote of the reproposed standard to clarify how the concepts of audit risk in this standard apply to audits of financial statements only and to integrated audits. The first paragraph has been revised to indicate that Auditing Standard No. 8 applies to either an audit of financial statements only or to an integrated audit. The first footnote also has been revised to clarify that, in integrated audits, the risks of material misstatement are the same for both the audit of financial statements and the audit of internal control.

4. Auditing Standard No. 9—Audit Planning

a. Background

Auditing Standard No. 9 describes the auditor's responsibilities for planning an integrated audit or an audit of financial statements only.

b. Planning and Supervision

The original proposed standard and the reproposed standard discussed both audit planning and supervision, similar to AU sec. 311. Some commenters observed that audit planning and supervision should be covered in separate standards.

The Board agrees that audit planning and supervision of engagement team members are distinct activities that should be covered in separate standards. Accordingly, the Board has divided the requirements of the reproposed planning and supervision standard into separate standards. Dividing the requirements for planning and supervision into separate standards does not affect the auditor's responsibilities for planning the audit or supervising the work of engagement team members.

c. Responsibilities of the Engagement Partner

AU sec. 311 stated, "The auditor with final responsibility for the audit may delegate portions of the planning and supervision of the audit to other firm personnel." Auditing Standard No. 9 uses the term "engagement partner" instead of "auditor with final responsibility for the audit" and states more directly that the engagement partner is responsible for properly planning the audit. The standard also allows the engagement partner to seek assistance from appropriate engagement team members in fulfilling his or her planning responsibilities. Because the requirements in Auditing Standard No. 9 apply to the engagement partner and engagement team members who assist the engagement partner in planning the audit, the standard uses the term "auditor," and a footnote was added to clarify that the requirements in the standard apply to the engagement partner and other engagement team members who participate in planning the audit.

d. Preliminary Engagement Activities

The reproposed standard included a note in paragraph 6 stating that the decision regarding continuance of the client relationship and the determination of compliance with independence and ethics requirements were not limited to preliminary engagement activities and should be reevaluated with changes in circumstances. One commenter expressed concern that the note did not describe the changes in circumstances for which it would be appropriate for the auditor to reevaluate these decisions. The acceptance and continuance of the client relationship are discussed in QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice.* Other PCAOB standards discuss certain circumstances that warrant reevaluating the client relationship.[183] Auditors also may reevaluate their engagement acceptance decision for other reasons. However, because auditors must comply with independence and ethics requirements throughout the audit, the note was moved in Auditing Standard No. 9 to modify paragraph 6.b. and revised to state that determination of compliance with independence and ethics requirements is not limited to preliminary engagement activities and should be reevaluated upon changes in circumstances.

e. Planning Activities

The reproposed standard stated that, as part of establishing the audit strategy and audit plan, the auditor should evaluate whether certain matters specified in the standard are important to the company's financial statements and internal control over financial reporting ("internal control") and, if so, how those matters would affect the auditor's procedures. The requirement in the reproposed standard was the same as in paragraph 9 of Auditing Standard No. 5, thus extending its application to an audit of financial statements.

Evaluation of the matters listed in paragraph 7 of Auditing Standard No. 9 can lead auditors to develop more effective audit strategies and audit plans. For example, evaluation 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, evaluation 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 financial statements.

Some commenters suggested changes to the requirement, including deleting some of the matters discussed in the requirement, moving other matters elsewhere within the standard, or making specific revisions to the language of the standard. Also, some commenters suggested using "should consider" instead of "should evaluate."

The Board considered the suggested changes to the standard and determined that those changes would not substantially improve the standard. Also, it is important for the language in this requirement to be identical to the language in Auditing Standard No. 5 to emphasize that this required procedure is to be performed only once in an integrated audit, with the results of the procedure to be applied in planning both the financial statement audit and the audit of internal control. Also, reframing the requirement from "should evaluate" to "should consider" would

[182] Paragraph 10 of Auditing Standard No. 8.

[183] *See, e.g.,* paragraphs .18–.21 of AU sec. 317, *Illegal Acts by Clients.*

weaken the requirement. Therefore, Auditing Standard No. 9 retains the wording from the reproposed standard.

f. Audit Strategy and Audit Plan

Auditing Standard No. 9 requires the auditor to take into account certain matters when establishing the overall audit strategy, including the reporting objectives of the engagement and the nature of the communications required by PCAOB standards; the factors that are significant in directing the activities of the engagement team; the results of preliminary engagement activities and the auditor's evaluation of certain important matters; and the nature, timing, and extent of resources necessary to perform the engagement.[184] These matters generally relate to information that auditors obtain through other required procedures. One commenter suggested that this requirement should discuss the need for specialists. Auditing Standard No. 9 was revised to include a reference to paragraph 16 regarding the requirement for the auditor to determine whether specialized skill or knowledge is needed to perform the engagement.

The reproposed standard required the auditor to develop and document an audit plan that includes the planned nature, timing, and extent of the risk assessment procedures. One commenter suggested that it was unnecessary to document the timing of the risk assessment procedures because risk assessment is an ongoing process that occurs throughout the execution of the audit. Auditing Standard No. 9 retains the requirement to document the timing of the risk assessment procedures. Identifying and appropriately assessing the risks of material misstatement provide a basis for designing and implementing responses to the risks of material misstatement, so the timing of the risk assessment procedures is important to determine the timing of other audit procedures.

The reproposed standard also required the auditor to develop and document the planned nature, timing, and extent of tests of controls and substantive procedures. One commenter suggested that the requirement should specify that the audit plan include planned tests at the "relevant assertion level." Auditing Standard No. 9 retains the requirement as reproposed. Audit procedures are not performed only at the assertion level, *e.g.,* certain general audit procedures and tests of certain entity-level controls in the audit of internal control over financial reporting. Therefore, it is not appropriate to update the standard with the suggested language.

g. Requirements for Multi-Location Engagements

Auditing Standard No. 9 establishes requirements that apply to audits of companies with operations in multiple locations or business units. Auditing Standard No. 9 requires the auditor to determine the extent to which audit 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. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual locations or business units. The auditor is required to assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit. Auditing Standard No. 9 also lists factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures. These requirements are risk-focused and aligned with the requirements in Auditing Standard No. 5.

An example was added to one of the factors in Auditing Standard No. 9 to highlight that the auditor's consideration of risks associated with a location or business unit includes whether significant unusual transactions are executed at that location or business unit, e.g., whether certain transactions were conducted at the location or business unit to achieve a particular accounting result. AU sec. 316 already requires the auditor to perform procedures regarding significant unusual transactions.

The reproposed standard included a statement, similar to Auditing Standard No. 5, that "The direction in paragraph 5 of Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement,* regarding incorporating an element of unpredictability in the auditing procedures means that the auditor should vary the nature, timing, and extent of audit procedures at locations or business units from year to year." Some commenters stated that the statement in the reproposed standard was unnecessarily prescriptive. After considering the comments received, the requirement regarding unpredictability was removed from the audit planning standard, and the requirements in Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement,* regarding incorporating an element of unpredictability were expanded to include discussion of varying the testing in the selected locations.[185] However, this does not change the requirements in Auditing Standard No. 5 regarding incorporating unpredictability in testing controls at individual locations in audits of internal control.[186]

The reproposed standard included a requirement for the auditor to 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 misstatements. One commenter was concerned that the use of the term "consolidated financial statements" is inconsistent with the terminology used elsewhere in the standards and that the financial statements of companies with multiple divisions might not meet the definition of consolidated. The use of "consolidated financial statements" is consistent with the term used in Auditing Standard No. 5. The use of the term "consolidated" applies to situations in which the company has multiple locations or business units. Auditing Standard No. 9 retains the language as reproposed.

Some commenters requested clarification on how the requirements are expected to be applied in audits in which part of the work is performed by other auditors of financial statements of individual locations or business units that are included in the consolidated financial statements. A paragraph was added to Auditing Standard No. 9 to clarify that the auditor should apply the requirements in paragraphs 11–13 to determine the locations or business units for testing when the auditor plans to use the work and reports of other independent auditors who have audited the financial statements of one or more of the locations or business units (including subsidiaries, divisions, branches, components, or investments) that are included in the consolidated financial statements. AU sec. 543, *Part of Audit Performed by Other*

[184] Paragraph 9 of Auditing Standard No. 9.

[185] Paragraph 5 of Auditing Standard No. 13.

[186] Paragraphs 61 and B13 of Auditing Standard No. 5.

Independent Auditors, describes the auditor's responsibilities when the auditor uses the work and reports of other independent auditors.[187]

h. Persons With Specialized Skill or Knowledge

Auditing Standard No. 9 indicates that the auditor should determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results. The responsibility has been extended from a similar requirement in AU sec. 311 regarding considering whether specialized information technology ("IT") skill or knowledge is needed in an audit. The requirement was extended to specialized skill or knowledge in areas besides IT, *e.g.,* valuation specialists, actuarial specialists, income tax specialists, and forensic specialists, because of the prevalent use of such individuals by auditors.

The reproposed standard included a note that described the term "specialized skill or knowledge" as persons engaged or employed by the auditor who have specialized skill or knowledge. Some commenters suggested that this note be removed because paragraph 17 included a similar description. The note was removed from Auditing Standard No. 9 because it was unnecessary and redundant.

One commenter suggested revising the standard to require the auditor to consider using a fraud specialist. The suggested requirement to consider using a fraud specialist was not added to Auditing Standard No. 9 because the requirement in the reproposed standard already covers fraud specialists, and the types of specialized skill or knowledge that might be needed on a particular audit depend on the particular circumstances and the skill and knowledge of the engagement team.

Some commenters suggested that the requirements relating to the involvement of specialists be reframed as "assisting" the auditor. Such a formulation is too narrow to describe the range of involvement of specialists, which could include providing assistance to the auditor or actually performing audit procedures.

Paragraph 17 of Auditing Standard No. 9 describes the required level of knowledge of the subject matter in terms of the general types of procedures that the auditor should be able to perform with regard to the person with specialized skill or knowledge. Paragraph 17, by itself, does not impose procedural requirements for working with persons with specialized skill or knowledge because those responsibilities already are described in either the supervision provisions of Auditing Standard No. 10, *Supervision of the Audit Engagement,* or AU sec. 336, *Using the Work of a Specialist,* as applicable.

5. Auditing Standard No. 10—Supervision of the Audit Engagement

a. Background

Auditing Standard No. 10 sets forth requirements for supervising the audit engagement, including supervising the work of engagement team members.

Auditing Standard No. 10 retains the basic requirements regarding supervision from AU sec. 311, with changes to align the requirements more closely with the other risk assessment standards. Auditing Standard No. 10 does not change the responsibilities for supervision from those in the supervision section of the reproposed standard on audit planning and supervision. However, the language in the standard has been revised in certain respects to describe more directly the supervisory responsibilities of the engagement partner and engagement team members who assist the engagement partner in supervision. As discussed later in this section, the Board has separate standards-setting projects regarding specialists and principal auditors, which will likely result in changes to the auditor's responsibilities regarding the auditor's use of specialists and use of other auditors, and, in turn, may result in changes to Auditing Standard No. 10.

b. Planning and Supervision

As discussed in section II.C.4.b., the original proposed standard and the reproposed standard included requirements for both audit planning and supervision, similar to AU sec. 311. Some commenters observed that audit planning and supervision should be covered in separate standards.

The Board agrees that audit planning and supervision of engagement team members are distinct activities that should be covered in separate standards. Accordingly, the Board has divided the requirements of the planning and supervision standard into separate standards. Dividing the requirements for planning and supervision into separate standards does not affect the auditor's responsibilities for planning the audit or supervising the work of engagement team members.

c. Objective

When the requirements for planning and supervision were divided into separate standards, the objective for supervision of the work of engagement team members was adapted from the elements of proper supervision in the reproposed standard. Auditing Standard No. 10 states, "The objective of the auditor is to supervise the audit engagement, including supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached." The revised objective does not alter the supervision responsibilities included in the original proposed standard or the reproposed standard.

d. Responsibilities of the Engagement Partner

AU sec. 311 stated, "The auditor with final responsibility for the audit may delegate portions of the planning and supervision of the audit to other firm personnel." Auditing Standard No. 10 uses the term "engagement partner" instead of "auditor with final responsibility for the audit."

Auditing Standard No. 10 states that the engagement partner is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for proper supervision of the work of engagement team members and for compliance with PCAOB standards, including standards regarding using the work of specialists,[188] other auditors,[189] internal auditors,[190] and others who are involved in testing controls.[191] As discussed previously, as the Board considers changes to the auditor's responsibilities regarding the auditor's use of specialists and use of other auditors, it also may consider changes to Auditing Standard No. 10.

Auditing Standard No. 10 allows the engagement partner to seek assistance from appropriate engagement team members in fulfilling his or her responsibilities pursuant to the standard. Engagement team members who assist the engagement partner in supervision should comply with the relevant requirements of Auditing Standard No. 10. The requirements in PCAOB standards for assignment of responsibilities to engagement team members also apply to assignments that involve assisting the engagement

[187] Paragraph 14 of Auditing Standard No. 9.

[188] *See* Section II.C.5.f.

[189] Ibid.

[190] AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.*

[191] Paragraphs 16–19 of Auditing Standard No. 5.

partner with his or her responsibilities pursuant to the standard.[192]

e. Supervision of the Work of Engagement Team Members

Previously adopted PCAOB standards use either the term "engagement team members" or the term "assistants." Auditing Standard No. 10 uses "engagement team members," which is consistent with the other risk assessment standards. The Board is amending other PCAOB standards to conform to this terminology.

Auditing Standard No. 10 describes the required supervisory activities that should be performed by the engagement partner and, as applicable, by other engagement team members with supervisory responsibilities.[193] Those activities include informing engagement team members of their responsibilities and information relevant to those responsibilities, directing engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities, and reviewing the work of engagement team members as described in the standard.

Auditing Standard No. 10 describes the factors that should be taken into account in determining the necessary extent of supervision, i.e., the extent of supervision necessary so that the work of engagement team members is performed as directed and appropriate conclusions are formed based on the results of their work.[194] Factors that affect the necessary extent of supervision include the risks of material misstatement, the nature of work assigned to the engagement team member, and the nature of the company, which includes the organizational structure of the company and its size and complexity. The extent of supervision of the work of an individual engagement team member increases or decreases, but cannot be eliminated, based on those factors. For example, the extent of supervision should be commensurate with the risks of material misstatement, which means, among other things, that the higher risk areas of the audit require more supervisory attention from the engagement partner.

One commenter suggested that the standard provide examples of "levels of supervision in relation to review," such as face-to-face review when reviewing higher risk areas. Auditing Standard No. 10 does not prescribe a particular method of review, so the engagement partner can determine the most effective way to comply with the requirements regarding the necessary nature of supervisory activities and necessary extent of supervision.

f. Persons with Specialized Skill or Knowledge and Other Auditors, Accounting Firms, and Individual Accountants

Auditing Standard No. 10 states that the engagement partner is responsible for, among other things, compliance with PCAOB standards regarding using of the work of specialists and refers to AU sec. 336. AU sec. 336 applies to situations in which the auditor engages a specialist in an area other than accounting or auditing and uses the work of that specialist as audit evidence.[195] Paragraphs 5–6 of Auditing Standard No. 10 describe the nature and extent of the supervisory activities necessary for proper supervision of a person with specialized skill or knowledge who participates in the audit and is either (a) employed by the auditor or (b) engaged by the auditor to provide services in a specialized area of accounting or auditing. AU sec. 336 has been amended to clarify when the auditor should look to the supervisory requirements in Auditing Standard No. 10 instead of AU sec. 336.

AU sec. 543 describes the principal auditor's [196] responsibilities for using the work and reports of other independent auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements presented. The principal auditor should look to the requirements in AU sec. 543 [197] in those situations. For situations in which the auditor engages an accounting firm or individual accountants to participate in the audit engagement and AU sec. 543 does not apply,[198] the auditor should supervise them in accordance with the requirements of Auditing Standard No. 10. AU sec. 543 has been amended to emphasize those points.

It should be noted, however, that the Board has separate standards-setting projects regarding specialists and principal auditors, which will include comprehensive reviews of AU sec. 336 and AU sec. 543, respectively, in light of, among other things, observations from the Board's inspection activities. Those projects will likely result in changes to the auditor's responsibilities regarding the auditor's use of specialists and use of other auditors, and, in turn, may result in changes to Auditing Standard No. 10.

g. Differences of Opinion Within an Engagement Team

The original proposed standard included a requirement, adapted from AU sec. 311.14, that the engagement partner and other engagement team members should make themselves aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among the engagement team members. Since the intention of including this provision was to require adequate documentation of disagreements, this paragraph was removed from the reproposed standard, and the documentation requirements from the original proposed standard were incorporated into an amendment to Auditing Standard No. 3, *Audit Documentation*.[199] The documentation requirements regarding disagreements among members of the engagement team or with others consulted on the engagement about final conclusions reached on significant accounting or auditing matters include documenting the basis for the final resolution of those disagreements. If an engagement team member disagrees with the final conclusions reached, he or she should document that disagreement.

One commenter indicated concern that the requirement for the engagement partner and other engagement team members to be aware of how disagreements should be handled has been removed. The commenter indicated that disagreements are a sensitive area and that it is important that engagement team members are aware of how disagreements should be handled. In connection with the requirement to direct engagement team members to bring significant accounting and auditing issues to the attention of the engagement partner or other engagement team members performing supervisory activities, Auditing Standard No. 10 also states that each engagement team member has a responsibility to bring to the attention of

[192] *See, e.g.* AU sec. 230.06 and paragraph 5 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

[193] Paragraph 5 of Auditing Standard No. 10.

[194] Paragraph 6 of Auditing Standard No. 10.

[195] AU sec. 336 also applies to situations in which the auditor uses the work of a specialist engaged or employed by management. The discussion in this section of the release focuses on the auditor's use of specialists who are employed or engaged by the auditor.

[196] AU sec. 543 uses the term "principal auditor" to refer to the auditor who issues the audit report on the financial statements presented.

[197] For integrated audits, *see* also paragraphs C8–C11 of Auditing Standard No. 5.

[198] Examples of situations that are not covered by AU sec. 543 include loan staff arrangements.

[199] Paragraph 12.d. of Auditing Standard No. 3.

appropriate persons, disagreements or concerns the engagement team member might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or the auditor's report regardless of how those disagreements or concerns may have arisen.[200]

6. Auditing Standard No. 11—Consideration of Materiality in Planning and Performing an Audit

a. Background

Auditing Standard No. 11 discusses the auditor's responsibilities for applying the concept of materiality, as described by the courts in interpreting the federal securities laws, in planning the audit and determining the scope of the audit procedures. The standard applies to integrated audits and audits of financial statements only.

b. Materiality in the Context of an Audit

Auditing Standard No. 11 discusses the concept of materiality that is applicable to audits performed in accordance with PCAOB standards, which is the articulation of materiality used by the courts in interpreting the federal securities laws.[201] The Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the * * * fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[202]

Some commenters questioned the use of the court's articulation in the reproposed standard and suggested that this articulation might be difficult for auditors to apply. Also, some commenters asked whether the use of this articulation of materiality, in contrast to the quotation from a FASB Concept Statement[203] used in AU sec. 312 was intended to result in a change in audit practice.

Although the discussion of materiality in the accounting literature might help auditors understand how accounting standards-setters view materiality in the context of preparation and presentation of financial statements, the concept of materiality that is relevant for audits to which PCAOB standards apply is the concept used by the courts in interpreting the Federal securities laws. Because the auditor has a responsibility to plan and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements, it is important for the auditor to plan and perform his or her audit procedures based on the applicable concept of materiality. Accordingly, Auditing Standard No. 11 uses the concept of materiality articulated by the courts.

Because the courts' articulation of the concept of materiality is not new, using that articulation in Auditing Standard No. 11 is not intended to result in changes in practice for most auditors. Auditing Standard No. 11 emphasizes that an auditor's consideration of materiality should reflect matters that would affect the judgment of a reasonable investor.

c. Establishing a Materiality Level for the Financial Statements as a Whole

Auditing Standard No. 11 requires the auditor to establish an appropriate materiality level for the financial statements as a whole.[204] This materiality level should be established in light of the particular circumstances based on factors that could influence the judgment of a reasonable investor. The standard states that this requirement includes consideration of the company's earnings and other relevant factors. This statement is intended to emphasize that a company's net earnings are often an important factor in the total mix of information available to a reasonable investor, but Auditing Standard No. 11 does not require the use of earnings as the basis for the established materiality level in all cases. Other factors besides earnings might be more relevant depending on the particular circumstances, *e.g.,* based on a company's industry or situations in which the company's earnings were near zero. Auditors are expected to consider the factors that would be relevant to the judgment of a reasonable investor.

d. Qualitative Considerations

The concept of materiality involves consideration of both quantitative and qualitative factors.[205] Under Auditing Standard No. 11, qualitative considerations can affect the auditor's establishment of materiality levels in the following ways:

- Establishing a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances. This involves matters such as consideration of the elements of the financial statements that are more important to a reasonable investor and the level of misstatements that would influence the judgment of a reasonable investor.
- Establishing lower levels of materiality for certain accounts or disclosures when, in light of the particular circumstances, there are certain accounts or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor. The requirement in the standard[206] is consistent with the principle of considering the judgment of a reasonable investor when establishing materiality levels 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 such circumstances:
  - 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.

Auditing Standard No. 11 does not allow the auditor to establish a materiality level for an account or disclosure at an amount that exceeds the materiality level for the financial statements as a whole.

The reproposed standard included a statement, adapted from AU sec. 312, that ordinarily it is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors.[207] One commenter suggested removing the word "ordinarily" from the statement because, in the commenter's view, it is not practical to design audit procedures to detect misstatements that are material based solely on qualitative factors. Auditing Standard No. 11 retains the

[200] Note to paragraph 5.b. of Auditing Standard No. 10.

[201] Paragraph 2 of Auditing Standard No. 11.

[202] *See TSC Industries Northway, Inc.,* 426 U.S. 438, 449 (1976). *See also Basic, Inc.* v. *Levinson,* 485 U.S. 224 (1988).

[203] Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information.* FASB Concepts Statements are not included in FASB's Codification of Accounting Standards.

[204] Paragraph 6 of Auditing Standard No. 11.

[205] Paragraph 3 of Auditing Standard No. 11.

[206] Paragraph 7 of Auditing Standard No. 11.

[207] AU sec. 312.20.

statement as proposed. This statement reflects the principle that judgments about whether a particular misstatement is material involve consideration of the particular circumstances, including the nature of the misstatement and its effect on the financial statements. Also, if an auditor is aware of potential misstatements that would be material based on qualitative factors, he or she has a responsibility to design audit procedures to detect such misstatements.

e. Tolerable Misstatement

The reproposed standard required the auditor to determine tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level.[208] Tolerable misstatement is a concept used in determining the scope of audit procedures. AU sec. 350, *Audit Sampling,* indicates that tolerable misstatement is the maximum amount of misstatement in an account or a class of transactions that may exist without causing the financial statements to be materially misstated.[209] Tolerable misstatement is required to be set at an amount less than the materiality level for the financial statements as a whole and for particular accounts or disclosures, if lower materiality levels were established for particular accounts or disclosures.

Some commenters suggested replacing the term "tolerable misstatement" in the reproposed standard with the term "performance materiality," which is the term used in the International Standards on Auditing ("ISA").

The Board decided to retain the term "tolerable misstatement" in its standards. The concept of tolerable misstatement is already understood by auditors, and the Board is not seeking to change the concept as described in PCAOB standards. Because the term "performance materiality" uses the word "materiality," it could be misunderstood, *e.g.,* by nonauditors, as having a meaning other than that intended in the standard. The concept of materiality that applies to financial statements of companies that are audited in accordance with PCAOB standards is rooted in case law and reflects a reasonable investor's perspective. In contrast, tolerable misstatement is a concept used in audit scoping decisions at the account level, considering potential uncorrected and undetected misstatement.

One commenter stated that the requirement to establish tolerable misstatement eliminated the need to establish a lower level of materiality for particular accounts or disclosures. However, the two concepts are designed for different purposes. The requirement to establish a lower materiality level is intended to address the need for a lower threshold when, in light of the particular circumstances, misstatements of lesser amounts have a substantial likelihood of influencing the judgment of a reasonable investor. As mentioned previously, tolerable misstatement is a concept used in audit scoping decisions at the account level, considering potential uncorrected and undetected misstatement.

The reproposed standard also required the auditor to take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of financial statements of prior periods. One commenter suggested that the Board should clarify its intent regarding this requirement and provide additional guidance regarding its application. Tolerable misstatement is affected by the expected level of misstatement in the account or disclosure, and the nature, cause, and amount of misstatements from prior periods are relevant to developing expectations about the level of misstatement. Generally, as the expected level of misstatement increases, the amount of tolerable misstatement decreases.

f. Consideration of Materiality for Multi-location Engagements

The reproposed standard included requirements for establishing materiality levels in multi-location engagements. The reproposed standard stated that when the auditor plans to perform procedures at selected locations or business units, the auditor should establish the materiality level for the individual locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements. The reproposed standard also stated that the materiality level for the selected locations or business units generally should be lower than the materiality level for the consolidated financial statements. Those requirements were an application of the fundamental principles to audits of consolidated financial statements of companies with multiple locations or business units.

Some commenters suggested removing the word "generally" as it could be misinterpreted as permitting the use of the materiality level for the consolidated financial statements as a whole for planning and performing audit procedures at the individual location or business unit level. Other commenters questioned how the requirements would be applied when a principal auditor makes reference to the report of another auditor in the auditor's report on consolidated financial statements in accordance with AU sec. 543.

After considering the comments, the Board has made certain clarifying revisions to the requirements for multi-location engagements.[210] First, the language in the standard has been revised to use term "tolerable misstatement" for an individual location to more clearly distinguish that term from the materiality level for the financial statements as a whole. In addition, the requirements were revised to state that tolerable misstatement for a location or business unit should be less than the materiality level for the financial statements as a whole. The word "generally" was removed from the requirements to reduce the risk of misinterpretation of the provision. Also, the phrase "to be used in performing audit procedures" has been removed from the requirement to determine tolerable misstatement for the individual locations or business units to avoid a misinterpretation about the principal auditor's responsibilities for situations in which the principal auditor makes reference to the report of the other auditor in accordance with AU sec. 543. Auditing Standard No. 11 requires the principal auditor to determine tolerable misstatement for the location or business unit audited by the other auditor, but the principal auditor is not expected to impose that determination of tolerable misstatement on the other auditor. Rather, tolerable misstatement for the location or business unit audited by the other auditor would be relevant to certain requirements under AU sec. 543[211] and in determining an appropriate amount of tolerable misstatement for the remaining locations or business units included in the consolidated financial statements.

[208] Paragraphs 8–9 of Auditing Standard No. 11.

[209] AU sec. 350.18.

[210] Paragraph 10 of Auditing Standard No. 11.

[211] For example, AU sec. 543.10 states that the auditor should adopt measures to assure the coordination of the principal auditor's activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements.

g. Reevaluating the Materiality Level and Tolerable Misstatement

The reproposed standard stated that the established materiality level and tolerable misstatement should be reevaluated if changes in the particular circumstances or additional information comes to the auditor's attention that are likely to influence the judgment of a reasonable investor. In addition, the reproposed standard provided examples of situations that would require such reevaluation, and additional examples were discussed in the release accompanying the reproposed standards.

Some commenters suggested that the examples in the release should be included in the reproposed standard. The examples in Auditing Standard No. 11 have been revised to clarify the types of situations that would require reevaluation of the established materiality level and tolerable misstatement.

The reevaluation required by Auditing Standard No. 11 is important because if that reevaluation results in a lower materiality level or levels and tolerable misstatement than the auditor's initial determination, the standard states that 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.[212]

Auditing Standard No. 11 does not allow the auditor to modify the established level or levels of materiality and tolerable misstatement solely because they are approximately equal to or are exceeded by the amount of uncorrected misstatements. Such a practice is inconsistent with the requirement to reevaluate the established materiality level or levels or tolerable misstatement if changes in the particular circumstances or additional information come to the auditor's attention that are likely to affect the judgments of a reasonable investor. Rather, Auditing Standard No. 14 establishes requirements for evaluating uncorrected misstatements[213] and describes the auditor's responsibilities in situations in which uncorrected misstatements approach established materiality level or levels used in planning and performing an audit.[214]

[212] Paragraph 12 of Auditing Standard No. 11.

[213] Paragraphs 17–23 of Auditing Standard No. 14.

[214] Paragraph 14.b. of Auditing Standard No. 14.

7. Auditing Standard No. 12—Identifying and Assessing Risks of Material Misstatement

a. Background

Auditing Standard No. 12 describes the auditor's responsibilities for the process of identifying and assessing risks of material misstatement in an audit of financial statements only and in an integrated audit. This process includes (1) performing information-gathering procedures, known as risk assessment procedures, and (2) identifying and assessing the risks of material misstatement using information obtained from the risk assessment procedures.

As discussed in the release accompanying the reproposed standards, the requirements in this standard are intended to improve the auditor's risk assessments and ability to focus on areas of increased risk in audits of financial statements only and in integrated audits. The effectiveness of a risk-based audit depends on whether the auditor identifies the risks of material misstatement and has an appropriate basis for assessing those risks. Inappropriate identification or assessment of risks of material misstatements can lead to overlooking relevant risks to the financial statements, e.g., business conditions that affect asset quality or create pressures to manipulate the financial statements, or assessing risks too low without having an appropriate basis for the assessment. In turn, these situations can lead to misdirected or inadequate audit work.

Auditing Standard No. 12 employs a top-down approach to risk assessment. Such an approach begins at the financial statement level and with the auditor's overall understanding of the company and its environment and works down to the significant accounts and disclosures and their relevant assertions. Also, the requirements for performing risk assessment procedures are designed to be scalable to companies of varying size and complexity.

In an integrated audit, the risks of material misstatement affect both the audit of financial statements and the audit of internal control, so the risk assessment process described in Auditing Standard No. 12 is for a single process that applies to both the audit of financial statements and the audit of internal control. Auditing Standard No. 12 seeks to enhance the integration of the audit of financial statements with the audit of internal control by aligning these risk assessment standards with Auditing Standard No. 5. Accordingly, Auditing Standard No. 12 reflects certain foundational risk assessment principles from Auditing Standard No. 5 that also apply to audits of financial statements. On the other hand, the provisions of this standard also are designed to be tailored for audits of financial statements only, *e.g.,* the requirements relating to the understanding of internal control over financial reporting.

b. Objective

Some commenters recommended that the Board revise the objective in the reproposed standard to indicate that the auditor's identification and assessment of risks are through understanding of the company and its environment. The objective in Auditing Standard No. 12 was retained from the reproposed standard. The revision suggested by the commenters is too narrow because Auditing Standard No. 12 requires other risk assessment procedures beyond obtaining an understanding of the company and its environment.

c. Performing Risk Assessment Procedures

The overarching requirement for risk assessment procedures in Auditing Standard No. 12 is that the auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for the identification and assessment of the risks of material misstatement, whether due to error or fraud, and to design further audit procedures.[215] Auditing Standard No. 12 discusses the auditor's responsibilities for determining and performing the risk assessment procedures necessary to satisfy that overarching requirement.[216]

Risks of material misstatement may exist at the financial statement level or at the assertion level. Risks of material misstatement also can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting. Since the risks of material misstatement come from various sources, the auditor's risk assessment procedures need to encompass both external factors and company-specific factors. Auditing Standard No. 12 requires the following risk assessment procedures:

[215] Paragraph 4 of Auditing Standard No. 12. The phrase "design further audit procedures" applies to substantive procedures and to tests of controls in the audit of financial statements and the audit of internal control over financial reporting.

[216] Paragraphs 5–58 of Auditing Standard No. 12.

• Obtaining an understanding of the company and its environment; [217]
• Obtaining an understanding of the company's internal control over financial reporting; [218]
• Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company; [219]
• Performing analytical procedures; [220]
• Conducting a discussion among engagement team members regarding the risks of material misstatement; [221] and
• Inquiring of the audit committee, management, and others within the company about the risks of material misstatement.[222]

The reproposed standard required the auditor to perform risk assessment procedures that are designed to help the auditor identify the areas of greater risk, appropriately assess those risks, and design and perform further audit procedures to address risks of material misstatements in the financial statements, whether due to error or fraud. One commenter suggested adding the phrase "and to design further audit procedures focused on the areas of greatest risk" to the end of the sentence in paragraph 4. The suggested language is not included in Auditing Standard No. 12 because that principle is already addressed in Auditing Standard No. 13.

One commenter on the reproposed standard asked for more discussion of the connection between the components of audit risk and the risk assessment process. That discussion has been added to Auditing Standard No. 8.[223]

d. Obtaining an Understanding of the Company and Its Environment

Like the reproposed standard, Auditing Standard No. 12 requires the auditor to obtain an understanding of the company and its environment to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement ("obtaining an understanding of the company").[224] These requirements are an expansion of requirements that were in AU sec. 311 regarding obtaining knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics as part of audit planning.[225] The expanded requirements are intended to focus the auditor on the degree of "knowledge of the company" that is necessary for a risk-based audit and to explain how knowledge of the company informs the auditor's identification and assessment of risk.

Auditing Standard No. 12 requires that the understanding of the company and its environment include understanding the following:
• Relevant industry, regulatory, and other external factors;
• The nature of the company;
• The company's selection and application of accounting principles, including related disclosures;
• The company's objectives and strategies and those related business risks that might reasonably be expected to result in risks of material misstatement; and
• The company's measurement and analysis of its financial performance.[226]

Auditing Standard No. 12 requires the auditor to 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.[227] This requirement builds on the requirement in paragraph 7 of Auditing Standard No. 9 to evaluate whether, among other things, the extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting is important to the company's financial statements and internal control over financial reporting and, if so, how those changes will affect the auditor's procedures. PCAOB standards have recognized that many risks of material misstatement arise due to changes in the company. For example, AU sec. 319 listed the following examples of circumstances that can result in risks or changes to existing risks: 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.[228]

Paragraphs 9–17 of Auditing Standard No. 12 explain more fully the necessary understanding of the preceding aspects of the company and its environment, e.g., what it means to obtain an understanding of the nature of the company. The discussion of relevant industry, regulatory, and other external factors is adapted from AU sec. 311. The discussion of the nature of the company is also adapted from AU sec. 311 and has been updated to reflect certain changes in business practices since AU sec. 311 was originally issued (e.g., to encompass alternative investments and financing arrangements and to recognize the development of new business models).

One commenter said that the requirement to obtain an understanding of the company and its environment should be revised because none of the aspects of the company and its environment listed in paragraph 7 is an event, condition, or company activity. However, the understanding of those aspects should lead the auditor to obtain an understanding of relevant events, conditions, and company activities. For example, obtaining an understanding of relevant industry, regulatory, and external factors helps an auditor understand the external conditions in which the company operates that represent risks of material misstatement at the financial statement level.

The reproposed standard contained a note about how the size and complexity of the company can affect the risks of misstatement and the controls necessary to address those risks. This note was intended to be a reminder to auditors that both size and complexity affect risks. One commenter stated that complexity rather than size is likely to heighten risk. Auditing Standard No. 12 retains the note as reproposed.[229] The size and complexity of the company can affect the risks of misstatement and the controls necessary to address those risks. Scaling the audit is most effective as a natural extension of the risk-based approach and applies to all audits, and the requirements in Auditing Standard No. 12 are intended to be scalable to companies of varying size and complexity. Auditing Standard No. 12 contains certain notes regarding scaling the audit based on a company's size and complexity.

(i). Additional Procedures to Obtain an Understanding of the Company and its Environment

The reproposed standard presented a list of procedures that the auditor should consider performing as part of obtaining an understanding of the company and its environment. These

[217] Paragraphs 7–17 of Auditing Standard No. 12.
[218] Paragraphs 18–40 of Auditing Standard No. 12.
[219] Paragraphs 41–45 of Auditing Standard No. 12.
[220] Paragraphs 46–48 of Auditing Standard No. 12.
[221] Paragraphs 49–53 of Auditing Standard No. 12.
[222] Paragraphs 54–58 of Auditing Standard No. 12.
[223] Paragraphs 8–11 of Auditing Standard No. 8.
[224] Paragraph 7 of Auditing Standard No. 12.
[225] AU secs. 311.06–.09.
[226] Paragraph 7 of Auditing Standard No. 12.
[227] Paragraph 8 of Auditing Standard No. 12.
[228] AU sec. 319.38.
[229] First note to paragraph 10 of Auditing Standard No. 12.

procedures include reading public information about the company, observing or reading transcripts of earnings calls, obtaining an understanding of compensation arrangements with senior management, and obtaining information about significant unusual developments regarding trading activity in the company's securities. The auditor's decisions about whether to perform one or more of the additional procedures and the extent of those procedures depend on whether the matters addressed in those procedures are important to the company's internal control or financial statements and whether such procedures are necessary to meet the overall requirements for obtaining an understanding of the company and performing risk assessment procedures.

Members of the Board's Standing Advisory Group ("SAG") suggested that these matters could provide valuable information for identifying risks of material misstatement, *e.g.,* to obtain information about business risks relevant to financial reporting or to identify incentives or pressures on management to manipulate financial results.[230] Also, the Public Oversight Board, *Panel on Audit Effectiveness, Report and Recommendations* ("*PAE Report*"), recommended that auditors consider published analysts' reports and forecasts when gaining an understanding of the company's business and industry, assessing risks, and evaluating identified misstatements.[231]

Commenters requested clarification of the Board's expectations regarding these procedures and expressed concern that the broad language used to describe some of the procedures might lead auditors to expend considerable efforts to decide and document whether to perform certain procedures. This requirement is not intended to require auditors to make a specific determination about each bit of data to which a procedure might be applied, e.g., to document each individual item of publicly available information to decide whether it should be reviewed.

Instead, the intention is for auditors to consider whether and to what extent such procedures should be performed to achieve the objectives in paragraphs 4 and 7 of Auditing Standard No. 12. For example, observing the company's earnings calls and other meetings with investors are likely to provide important information about the measurement and review of the company's financial performance, particularly the performance measures monitored by investors and analysts. Likewise, an understanding of compensation arrangements with senior management often can provide important information about incentives or pressures on management to manipulate the financial statements.

Auditing Standard No. 12 was revised to clarify that considering whether to perform the procedures listed in paragraph 11 also includes consideration of the extent of the procedures.

(ii). Selection and Application of Accounting Principles, Including Related Disclosures

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.[232] Auditing Standard No. 12 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 are consistent with the applicable accounting framework and the accounting principles used in the relevant industry.[233] Such procedures can provide important information for identifying relevant matters such as (1) accounts that are susceptible to misstatement, e.g., if an account balance is determined using accounting principles that are inconsistent with the applicable financial reporting framework or (2) more general conditions that affect risks of material misstatement, *e.g.,* if the company's selection or application of accounting principles is more aggressive than prevailing practices in the relevant industry.

In connection with obtaining an understanding of the applicable financial reporting framework and evaluating the company's selection and application of accounting principles, including related disclosures, Auditing Standard No. 12 requires the auditor to develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.[234] The language in this requirement was revised to clarify that the auditor should develop an expectation about the disclosures as part of the risk assessment procedures and that the expectations should be based on the disclosures necessary for the fair presentation of the financial statements in conformity with the applicable financial reporting framework.

Auditing Standard No. 12 also presents a list of matters that, if present, are relevant to the necessary understanding of the company's selection and application of accounting principles.[235] The amount of auditor attention devoted to an individual matter would depend on its importance in meeting the overall requirements for obtaining an understanding of the company and performing risk assessment procedures.[236]

(iii). Company Objectives, Strategies, and Related Business Risks

The reproposed standard required 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 reasonably be expected to result in material misstatement of the financial statements. The *PAE Report* recommended that auditors be required to obtain an understanding of the company's business risks.[237]

Commenters on the reproposed standard requested additional discussion about business risks, including going concern risks, fraud risks, and how business risks can result in misstatements of the financial statements. Additional discussion has been added to Auditing Standard No. 8 and Auditing Standard No. 12.[238]

Auditing Standard No. 12 discusses how business risks can lead to misstatements and provides examples of business risks that may result in a risk of material misstatement of the financial statements.[239] 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

[230] February 16, 2005. Webcasts of SAG meetings are available on the Board's Web site at: *http://www.pcaobus.org/News_and_Events/Webcasts.*

[231] Public Oversight Board, *Panel on Audit Effectiveness, Report and Recommendations* (August 31, 2000), p. 58.

[232] *See* AU sec. 316 and AU sec. 380, *Communication With Audit Committees.*

[233] Paragraph 12 of Auditing Standard No. 12.

[234] *Ibid.*

[235] Paragraph 13 of Auditing Standard No. 12.

[236] Paragraphs 4 and 7 of Auditing Standard No. 12.

[237] *PAE Report,* p. 20.

[238] Paragraph 6 of Auditing Standard No. 8 and the note to paragraph 15 of Auditing Standard No. 12.

[239] Paragraphs 5 and 14–15 of Auditing Standard No. 12.

might include financing risks (*e.g.,* access to necessary financing) or product risks (*e.g.,* investments in certain financial products).

(iv). The Company's Measurement and Analysis of its Financial Performance

The risk assessment procedures in the reproposed standard included obtaining an understanding of the company's performance measures. The purpose of obtaining that understanding is to identify those performance measures, whether external or internal, that affect the risks of material misstatement. For example, understanding performance measures can help the auditor identify accounts or disclosures that might be susceptible to manipulation to achieve certain performance targets (or to conceal failures to achieve those targets) or to understand how management uses performance measures to monitor risks affecting the financial statements.

Commenters requested clarification regarding the examples of performance measures. A note was added to Auditing Standard No. 12 to explain the significance of the individual examples.[240]

e. Obtaining an Understanding of Internal Control Over Financial Reporting

Auditing Standard No. 12 describes the auditor's responsibilities for obtaining an understanding of internal control over financial reporting ("understanding of internal control"). Auditing Standard No. 12 requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.[241] 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 requirements in AU sec. 319, the requirements in Auditing Standard No. 12 indicate that although the auditor's primary focus is on internal control over financial reporting, the auditor may obtain an understanding of controls related to operations or compliance objectives if they pertain to data that the auditor plans to use in applying auditing procedures.[242]

Auditing Standard No. 12 sets forth certain principles regarding the sufficiency of the auditor's understanding of internal control. The size and complexity of the company; the auditor's existing knowledge of the company's internal control; the nature of the company's internal controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting affect the nature, timing, and extent of procedures necessary to obtain an understanding of internal control. For example, the auditor's procedures to obtain an understanding of internal control would be more extensive when the auditor plans to test controls more extensively (*e.g.,* in an integrated audit), the company's internal control is more complex, or the company's controls have changed significantly.

The reproposed standard stated that the auditor's understanding of internal control includes evaluating the design of controls and determining whether the controls are implemented. Commenters observed that the reproposed standard stated that walkthroughs that include the necessary procedures ordinarily are sufficient to evaluate design effectiveness, but the reproposed standard did not make a similar statement about the use of walkthroughs to determine whether controls have been implemented. Auditing Standard No. 12 has been revised to include a statement that walkthroughs that include the procedures described in the standard ordinarily are sufficient to determine whether a control has been implemented.[243] Under Auditing Standard No. 12, as under AU sec. 319,[244] the amount of audit attention devoted to design and operating effectiveness will vary based on the auditor's plan for testing controls. For example, if the auditor plans to test controls, more attention should be devoted to controls that the auditor plans to test.

(i). Obtaining an Understanding of Individual Components of Internal Control Over Financial Reporting

To describe the auditor's responsibilities for obtaining an understanding of internal control, it was necessary to describe the components of internal control over financial reporting. The components described in Auditing Standard No. 12 are similar to those in AU sec. 319.[245] Auditing Standard No. 12 also states that auditors may use other suitable, recognized frameworks[246] in accordance with the provisions of the standard. If the auditor uses a suitable, recognized internal control framework with components that differ from those in the standard, the auditor should adapt the requirements in the standard for the components in the framework used.[247]

(ii). Control Environment

Auditing Standard No. 12 requires the auditor 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.[248]

Although this requirement is aligned with a similar requirement in Auditing Standard No. 5 for evaluating the control environment, the auditor's process for assessing the control environment in an audit of financial statements only is not expected to be the same as that required when expressing an opinion on internal control over financial reporting. For audits of financial statements only, Auditing Standard No. 12 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.[249]

Because of the importance of an effective control environment to address fraud risks, Auditing Standard No. 12 states that if the auditor identifies a control deficiency in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor.[250]

(iii) The Company's Risk Assessment Process

Auditing Standard No. 12 requires the auditor to obtain an understanding of management's risk assessment process for (a) identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud, (b) assessing the likelihood and significance of misstatements resulting from those risks, and (c) deciding about

[240] Paragraph 17 of Auditing Standard No 12.

[241] Paragraph 18 of Auditing Standard No. 12.

[242] Paragraph 19 of Auditing Standard No. 12.

[243] Paragraph 20 of Auditing Standard No. 12.

[244] AU sec. 319.58.

[245] Paragraph 21 of Auditing Standard No. 12.

[246] *See* Securities Exchange Act Release No. 34–47986 (June 5, 2003) for a description of the characteristics of a suitable, recognized framework.

[247] Paragraph 22 of Auditing Standard No. 12.

[248] Paragraph 24 of Auditing Standard No. 12.

[249] Ibid.

[250] Paragraph 25 of Auditing Standard No. 12.

actions to address those risks.[251] The standard also requires the auditor to obtain an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.[252] Compliance with these requirements will help make sure that the auditor's risk assessments are appropriately informed by management's risk assessments and the controls that management put in place to address the risks.

(iv) Information and Communication

The reproposed standard required the auditor to obtain an understanding of the information system, including the related business processes, relevant to financial reporting. One commenter suggested removing the requirement to understand the company's business processes. The requirement was retained as reproposed.[253] Obtaining an understanding of the company's business processes assists the auditor in obtaining an understanding of how transactions are initiated, authorized, processed, and recorded. Also, the requirement to understand business processes is a recommendation in the *PAE Report.*[254] Auditing Standard No. 12 describes the necessary understanding of business processes to help auditors identify those business processes that are relevant to financial reporting.[255]

Auditing Standard No. 12 also contains requirements for understanding the period-end financial reporting process [256] and describes important elements of that process.[257] Because the period-end financial reporting process is a common source of potential misstatements, 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. Auditing Standard No. 12 requires the auditor only to obtain an understanding [258] of the process, as compared to Auditing Standard No. 5, which requires the auditor also to evaluate that process in the audit of internal control.

To appropriately highlight the importance of IT risks in determining the scope of the audit, the standard requires the auditor to obtain an understanding of how IT affects the company's flow of transactions. The standard also contains a note that states that the identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the approach used to identify significant accounts and disclosures and their relevant assertions and, when applicable, to select the controls to test, as well as to assess risk and allocate audit effort.

Regarding the auditor's understanding of communication, one commenter suggested that the standard clarify that the auditor should understand how the company communicates financial reporting roles and responsibilities and significant matters relating to financial reporting. The requirement in Auditing Standard No. 12 has been revised to clarify that point.[259]

(v) Control Activities

The reproposed standard required the auditor to 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 under AU sec. 319, a more extensive understanding of control activities is needed in areas in which the auditor plans to test controls. Thus, for purposes of evaluating the effectiveness of internal control over financial reporting in an integrated audit, 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.

Some commenters expressed concern that the language in the requirement could be misinterpreted as requiring the auditor to obtain an understanding of all controls, even in an audit of financial statements only in which the auditor does not plan to test controls. A few commenters suggested framing the requirement in terms of understanding control activities relevant to the audit.

The Board did not intend to expand the auditor's responsibilities for obtaining an understanding of control activities beyond what is required in AU sec. 319. The discussion in Auditing Standard No. 12 on obtaining an understanding of control activities has been revised, primarily using language adapted from AU sec. 319, to clarify that the substance of the requirement has not changed.[260]

(vi). Performing Walkthroughs

The original proposed standard referred auditors to Auditing Standard No. 5 for a discussion of the performance of walkthroughs. Some commenters on the original proposed standard stated that the standard should include a discussion of walkthroughs rather than referring to Auditing Standard No. 5. The reproposed standard included a discussion of performing walkthroughs as part of meeting certain specified objectives, which paralleled a requirement in Auditing Standard No. 5 [261] regarding understanding likely sources of potential misstatements. Some commenters expressed concerns that the discussion would lead to unnecessary walkthroughs, particularly in audits of financial statements only.

The intention of including the discussion of walkthroughs was to explain how to perform walkthroughs rather than to impose requirements regarding when walkthroughs should be performed. The standard has been revised to focus on how the auditor should perform walkthroughs, *e.g.,* in connection with understanding the flow of transactions in the information system relevant to financial reporting, evaluating the design of controls relevant to the audit, and determining whether those controls have been implemented.[262] The discussion of the objectives for understanding likely sources of potential misstatements has been removed from Auditing Standard No. 12, so those objectives would continue to apply only to integrated audits.

(vii). Relationship of Understanding of Internal Control to Tests of Controls

Auditing Standard No. 12, like the reproposed standard, contains a discussion about the relationship between obtaining an understanding of controls and testing controls, including entity-level controls.[263] The requirements in Auditing Standard No. 12 clarify that the objective of obtaining an understanding of internal control as a risk assessment procedure is different from testing controls for the purpose of assessing control risk [264] or for the purpose of expressing an opinion on internal control over financial reporting

[251] Paragraph 26 of Auditing Standard No. 12.

[252] Paragraph 27 of Auditing Standard No. 12.

[253] Paragraph 28 of Auditing Standard No. 12.

[254] *PAE Report,* p. 15.

[255] Paragraphs 28–32 of Auditing Standard No. 12.

[256] AU sec. 319.49 used the term "financial reporting process used to prepare the entity's financial statements," but Auditing Standard No. 12 uses the same term as used in Auditing Standard No. 5.

[257] Paragraphs 28 and 32 of Auditing Standard No. 12.

[258] Paragraph 20 of Auditing Standard No. 12 discusses procedures that the auditor performs to obtain an understanding of internal control.

[259] Paragraph 33 of Auditing Standard No. 12.

[260] AU sec. 319.42 and paragraph 34 of Auditing Standard No. 12.

[261] Paragraph 34 of Auditing Standard No. 5.

[262] Paragraph 37 of Auditing Standard No. 12.

[263] Paragraph 39 of Auditing Standard No. 12.

[264] Paragraphs 16–31 of Auditing Standard No. 13.

in the audit of internal control.[265] The standard allows the auditor the flexibility of obtaining an understanding of internal control concurrently with performing tests of controls if he or she obtains sufficient appropriate evidence to achieve the objectives of both procedures.[266]

f. Information Obtained from Past Audits and Other Engagements

(i). Information from Past Audits

The reproposed standard included a requirement for the auditor to incorporate knowledge obtained during past audits into the auditor's process for identifying risks of material misstatement. One commenter asked for clarification of the meaning of the term "incorporate." Two commenters stated that the most important issue is to determine whether information from past audits is still relevant.

The term "incorporate" is not new and should be familiar to most auditors. For example, it has been used in AU sec. 316 regarding the requirement to incorporate an element of unpredictability in the audit in response to fraud risks. The requirement in the reproposed standard was similar to a requirement in Auditing Standard No. 5 to incorporate knowledge obtained during past audits in subsequent year audits of internal control.[267] Accordingly the term has been retained in Auditing Standard No. 12.

Auditing Standard No. 12 also states that if the auditor plans to limit the nature, timing, or extent of his or her risk assessment procedures by relying on information from past audits, the auditor should evaluate whether the prior-years' information remains relevant and reliable.[268]

(ii). Information from Other Engagements

The reproposed standard included a requirement for the auditor to take into account relevant information obtained through other engagements performed by the auditor for the company.[269] This requirement was intended to focus on the responsibility to take relevant information into account in identifying and assessing risks rather than to prescribe a particular method for obtaining that information.

Some commenters suggested that the requirement should be limited to consideration of other engagements performed by the engagement partner. The suggested change would weaken the standard. Limiting the consideration of information to engagements performed for the company by the engagement partner is too narrow because it omits other important information sources that are available to the engagement team. Also, limiting the consideration to engagements performed by the engagement partner is inconsistent with prior PCAOB standards. For example, AU sec. 311.04 stated that procedures the auditor may consider in planning an audit usually involve discussions with other firm personnel, and includes the following example "Discussing matters that may affect the audit with firm personnel responsible for non-audit services to the entity." Also, paragraph 03 of AU sec. 9311, *Planning and Supervision: Auditing Interpretations of Section 311,* stated:

> The auditor should consider the nature of non-audit services that have been performed. He should assess whether the services involve matters that might be expected to affect the entity's financial statements or the performance of the audit, for example, tax planning or recommendations on a cost accounting system. If the auditor decides that the performance of the non-audit services or the information likely to have been gained from it may have implications for his audit, he should discuss the matter with personnel who rendered the services and consider how the expected conduct and scope of his audit may be affected. In some cases, the auditor may find it useful to review the pertinent portions of the work papers prepared for the non-audit engagement as an aid in determining the nature of the services rendered or the possible audit implications.

Other commenters suggested that the requirement be revised to use more of the language from AU sec. 9311. The requirement in Auditing Standard No. 12 [270] has been revised as follows:

> The auditor should obtain an understanding of the nature of the services that have been performed for the company by the auditor or affiliates of the firm[271] and should take into account relevant information obtained from those engagements in identifying risks of material misstatement.[272]

One commenter stated that audit firms will need to develop very costly reporting systems to enable them to convey relevant information about nonassurance engagements to audit engagement teams. Existing PCAOB and SEC rules already require firms to track and report nonaudit services provided to the company. Complying with these requirements would mean that the audit firms have a mechanism in place to track these services. For example, PCAOB Rules 3524 [273] and 352 [274] require the auditor to describe to the company's audit committee, among other things, the scope of and the potential effect on independence of other services provided by the firm. It is expected that the system used to capture, track, and monitor these services for compliance with these PCAOB independence rules would also be applicable to comply with the requirements of Auditing Standard No. 12.

g. Performing Analytical Procedures

The reproposed standard retained requirements from AU sec. 329, *Analytical Procedures,* to perform analytical procedures during the planning phase of the audit.[275] Such analytical procedures are, in essence, risk assessment procedures, so the respective requirements and direction have been incorporated into Auditing Standard No. 12.[276] One commenter stated that it is unclear whether the PCAOB intends a change in practice regarding the execution of analytical procedures performed as risk assessment procedures, e.g., because the requirements in the reproposed standard discussed developing expectations and comparing them to recorded amounts. AU sec. 329, states that analytical procedures involve developing expectations and comparing those expectations to recorded amounts.[277]

Auditing Standard No. 12 states that analytical procedures performed as risk assessment procedures often use data that is preliminary or data that is aggregated at a high level and that in those instances such analytical procedures are not designed with the level of precision necessary for substantive analytical procedures.[278] In those situations, the auditor's expectations in performing analytical procedures as risk assessment procedures do not require the same

[265] Paragraph B1 of Auditing Standard No. 5.

[266] Paragraph 39 of Auditing Standard No. 12.

[267] Paragraph 57 of Auditing Standard No. 5.

[268] Paragraph 43 of Auditing Standard No. 12.

[269] PCAOB Rule 1001, *Definitions of Terms Employed in Rules,* states that, when used in rules of the PCAOB, unless the context otherwise requires, "[t]he term 'auditor' means both public accounting firms registered with the Public Company Accounting Oversight Board and associated persons thereof."

[270] Paragraph 45 of Auditing Standard No. 12.

[271] *See* PCAOB Rule 3501(a)(i), which defines "affiliate of the accounting firm."

[272] Paragraph 7 of Auditing Standard No. 9.

[273] PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services.*

[274] PCAOB Rule 3526, *Communication With Audit Committees Concerning Independence.*

[275] AU secs. 329.06–.08.

[276] Paragraphs 46–48 of Auditing Standard No. 12.

[277] AU sec. 329.05.

[278] Paragraph 48 of Auditing Standard No. 12.

degree of precision as substantive analytical procedures.

h. Conducting a Discussion Among Engagement Team Members Regarding Risks of Material Misstatement

Like the reproposed standard, Auditing Standard No. 12 includes a requirement that key engagement team members discuss (1) the company's selection and application of accounting principles, including related disclosure requirements and (2) the susceptibility of the company's financial statements to material misstatement due to error or fraud.[279] The standard explains that key engagement team members include the engagement partner and all engagement team members who have significant engagement responsibilities.[280] 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.

One commenter stated that the requirement for participation in the discussion among engagement team members on the reproposed standard should be revised to use the language in ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment,* so that the engagement partner makes the determination of what needs to be reported to whom on a "need to know" basis.

The language in Auditing Standard No. 12 was retained as reproposed. The Board believes that the discussion among engagement team members is an important part of the auditor's risk assessment procedures. Through its oversight activities, the Board has observed deficiencies relating to discussions among engagement team members regarding fraud risks, including instances in which key engagement team members did not participate.[281]

(i). *Discussion of the Potential for Material Misstatement Due to Fraud*

A number of comments were received regarding the requirements for discussing the risks of material misstatement due to fraud.

One commenter suggested that the standard should require the auditor to consider using a fraud specialist. The Board believes that this point is already covered by the requirement in Auditing Standard No. 9 to evaluate whether a person with specialized skill or knowledge is needed to assess risks.[282]

One commenter suggested that the requirement to discuss how the financial statements could be materially misstated through omitting or presenting incomplete disclosures also should include the possibility of presenting inaccurate disclosures. The requirement has been revised to include that topic.[283]Another commenter stated that the standard should provide more "guidance" about how fraud risks relate to disclosures. The manner in which management might intentionally omit disclosures or present inaccurate or incomplete disclosures to commit or conceal intentional misstatement of the financial statements necessarily depends on the circumstances, including the incentives or pressures and the opportunities to manipulate the financial statements. The discussion of fraud risks required by the standard should prompt engagement team members to consider ways in which omissions or inaccuracies in disclosures might be involved with fraudulent financial reporting.

Another commenter stated that the requirement for the auditor to emphasize certain matters regarding fraud to the engagement team members during the fraud risk discussion does not assign the responsibility to a specific person. The requirement focuses on the communication of important matters rather than on the person communicating the matters. Since the engagement partner has the overall responsibility for the audit engagement, the engagement partner is likely to be the most appropriate person to make the communications. However, Auditing Standard No. 12 allows the communications to be made by another engagement team member, when appropriate.

(ii) *Communication Among Engagement Team Members*

Auditing Standard No. 12 states that communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change. This requirement carries forward and builds upon a requirement in AU sec. 316.[284]

i. Inquiring of the Audit Committee, Management, and Others Within the Company About the Risks of Material Misstatement

Like the reproposed standard, Auditing Standard No. 12 requires the auditor to make inquiries of the audit committee, or equivalent (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.[285] The requirement to inquire of others who "might reasonably be expected to have information" is similar to a requirement in AU sec. 316 for making inquiries of others about the existence or suspicion of fraud, and it establishes a principle to guide the auditor in determining those other persons to whom the inquiries should be addressed.[286]

(i). Inquiries Regarding Fraud Risks

The reproposed standard also required the auditor to make inquiries of the audit committee (or its chair), management, the internal audit function, and others within the company about the risks of fraud. Commenters suggested that the requirements for identifying other individuals within the company to whom inquiries should be directed should include determining the extent of such inquiries. Auditing Standard No. 12 reflects the suggested revision to that requirement because inquiries of other individuals should be designed to obtain information relevant to identifying and assessing fraud risks.[287]

The reproposed standard included a requirement to take into account the fact that management is often in the best position to commit fraud when evaluating management's responses to inquiries about fraud risks and determining when it is necessary to corroborate management's responses. One commenter stated that the requirement was unclear and the use of the term "take into account" did not seem consistent with the Board's explanation in the release accompanying the reproposed standards. This requirement has been revised to clarify the requirement and to use "take into account" in a manner that is consistent with the other PCAOB standards.[288]

Auditing Standard No. 12 requires that the auditor use his or her

[279] Paragraph 49 of Auditing Standard No. 12.

[280] Paragraph 50 of Auditing Standard No. 12.

[281] PCAOB Release 2007–001, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud* (January 22, 2007).

[282] Paragraphs 16–17 of Auditing Standard No. 12.

[283] Paragraph 52 of Auditing Standard No. 12.

[284] AU sec. 316.18.

[285] Paragraph 54 of Auditing Standard No. 12.

[286] AU sec. 316.24.

[287] Paragraph 57 of Auditing Standard No. 12.

[288] Paragraph 58 of Auditing Standard No. 12.

knowledge of the company and its environment, as well as information from other risk assessment procedures, to determine the nature of the inquiries about risks of material misstatement. This requirement carries forward and builds upon a requirement in AU sec. 316.[289]

Auditing Standard No. 12 includes an additional required inquiry of the internal auditor about whether he or she is aware of instances of management override of controls and the nature and circumstances of such overrides. Also, Auditing Standard No. 12 requires the auditor to make inquiries of management and the audit committee, or equivalent regarding tips or complaints about the company's financial reporting.[290] These required inquiries were added in light of research indicating that many incidents of fraud are uncovered through tips.[291] These inquiries can provide important evidence about fraud risks.

Auditing Standard No. 12 requires the auditor, when evaluating management's responses to inquiries about fraud risks and determining when it is necessary to corroborate management's responses, to take into account the fact that management is often in the best position to commit fraud. The standard also requires the auditor to obtain evidence to address inconsistencies in responses to inquiries. This requirement carries forward and builds upon a requirement in AU sec. 316.[292]

j. Identifying and Assessing the Risks of Material Misstatement

Auditing Standard No. 12 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.[293] This process involves:

- Identifying risks of misstatement using information obtained from risk assessment procedures and considering the characteristics of the accounts and disclosures in the financial statements.
- Evaluating whether the identified risks relate pervasively to the financial statements as a whole and potentially affect many assertions.
- Evaluating the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected. This includes evaluating how risks at the financial statement level could affect risks at the assertion level.
- Assessing the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements. In making this assessment, the auditor may take into account the planned degree of reliance on controls that the auditor plans to test, if the auditor performs tests of controls in accordance with PCAOB standards.
- Identifying significant accounts and disclosures and their relevant assertions.
- Determining whether any of the identified and assessed risks of material misstatement are significant risks.[294]

One commenter suggested that the word "material" should be inserted before the word "misstatement" in paragraph 56.a. of the reproposed standard. No change was made to Auditing Standard No. 12 because inserting the word "material" would inappropriately narrow the auditor's focus on only material risks too early in the process of identifying and assessing risks of misstatement, i.e., before assessing the likelihood and magnitude of potential misstatements related to the risks.

Commenters suggested that the standard should clarify that the likelihood and magnitude of potential misstatements should be considered in determining which risks are significant risks. Auditing Standard No. 12 includes an additional requirement that states, "To determine whether an identified and assessed risk is a significant risk, the auditor should evaluate whether the risk requires special audit consideration because of the nature of the risk or the likelihood and potential magnitude of misstatement related to the risk."[295] Also, the list of factors that should be evaluated in determining which risks are significant risks was expanded to include "the effect of the quantitative and qualitative risk factors discussed in paragraph 60 of the standard [on identifying significant accounts and disclosures and their relevant assertions] on the likelihood and potential magnitude of misstatements."[296] Including this new factor highlights the relationship between the identification of significant accounts and disclosures and their relevant assertions and the identification of significant risks. Specifically, risk factors that form the basis for identifying significant accounts and disclosures and their relevant assertions also inform the identification of significant risks, and significant risks affect one or more relevant assertions of significant accounts or disclosures.

Another commenter on the reproposed standard suggested that the term "likelihood" be defined more in terms of reasonable possibility as that term is used in Auditing Standard No. 5. However, that change would be inconsistent with the requirement to assess the likelihood of misstatements, *i.e.,* the possibility that the risk would result in misstatement of the financial statements.

One commenter indicated that the requirement in the note to paragraph 59.c. of the reproposed standard "inappropriately infers that the auditor should, and can, associate the risks at the financial statement level with particular assertions in order to assess risks at the assertion level." Auditing Standard No. 8 states that risks of material misstatement at the financial statement level have a pervasive effect on the financial statements as a whole and potentially affect many assertions, and the standard provides examples of how risks at the financial statement level can result in misstatements.[297] It is important for the auditor to take into account risks of material misstatement at the financial statement level in order to evaluate types of misstatements that could occur.

Under PCAOB standards, significant accounts and disclosures and their relevant assertions are identified based upon their risk characteristics. Thus, the auditor needs to identify and assess the risks in order to identify the relevant assertions of significant accounts and disclosures in accordance with PCAOB standards. For example, Auditing Standard No. 5 requires the auditor to identify significant accounts and disclosures and their relevant assertions in integrated audits.[298] Also, AU sec. 319 required the auditor to perform substantive procedures for the relevant assertions of significant accounts and

[289] AU sec. 316.24.

[290] Paragraph 56 of Auditing Standard No. 12.

[291] *See, e.g.,* Association of Certified Fraud Examiners, *2008 Report to the Nation on Occupational Fraud & Abuse* (2008).

[292] AU sec. 316.27.

[293] Under Auditing Standard No. 12, the auditor has a responsibility to perform risk assessment procedures that provide an appropriate basis for his or her risk assessment. Auditing Standard No. 12 does not include the provision in the prior interim standards that allowed the auditor to assess risk at the maximum solely for efficiency reasons. Rather, the auditor needs to have a sufficient understanding of the company and its environment, including its internal control, in order to determine the risks of material misstatement and, in turn, to design effective tests of controls and substantive procedures.

[294] Paragraph 59 of Auditing Standard No. 12.

[295] Paragraph 70 of Auditing Standard No. 12.

[296] Paragraph 71 of Auditing Standard No. 12.

[297] Paragraph 6 of Auditing Standard No. 8.

[298] Paragraph 28 of Auditing Standard No. 5.

disclosures for all audits of financial statements, which implicitly required the auditor to identify those accounts, disclosures, and assertions.[299] Auditing Standard No. 12 imposes a more explicit requirement on the auditor to identify significant accounts and disclosures and their relevant assertions in all audits.

(i). Factors Relevant To Identifying Fraud Risks

Auditing Standard No. 12 requires that the auditor 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.[300] The reproposed standard included a paragraph that stated that the auditor should not assume that all of the fraud risk factors discussed in must be observed to conclude that a fraud risk exists. Commenters suggested that the language was not clear as to the action that auditors would need to take to "not assume." The paragraph has been revised to clarify that all of the conditions are not required to be observed or evident to conclude that a fraud risk exists.[301]

(ii). Consideration of the Risk of Omitted or Incomplete Disclosures

The reproposed standard stated that the auditor's evaluation of fraud risk factors should include an evaluation of how fraud could be perpetrated or concealed by omitting required disclosures or by presenting incomplete disclosures. One commenter stated that the requirement should also include consideration of the possibility of presenting inaccurate disclosures. Other commenters stated that the requirement should be revised to refer to disclosures required by the applicable financial reporting framework. The requirement has been revised to encompass inaccurate disclosures and to refer to disclosures required for the fair presentation of the financial statements in conformity with the applicable financial reporting framework.[302]

(iii). Presumption of Fraud Risk Involving Improper Revenue Recognition

Like the reproposed standard, Auditing Standard No. 12 contains a requirement that the auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.[303] One commenter recommended rewording this paragraph to state that while revenue recognition should be presumed to be a higher level of risk, there are exceptions. The requirement was retained as stated in the reproposed standard because a significant number of financial reporting frauds relate to revenue recognition.[304]

k. Definition of Significant Risk

The reproposed standard defined significant risk as a risk of material misstatement that requires special audit consideration. Some commenters stated that the definition of "significant risk" in the reproposed standard should be revised to indicate that significant risks are "identified risks" and that they are determined using the "auditor's judgment" or risks that the auditor "determines." Adding a reference to the auditor's determination or auditor's judgment is unnecessary because those points are inherent in the requirements for identifying significant risks, *e.g.,* in the required evaluation of the likelihood and potential magnitude of misstatements related to the risk. Similarly, the reference to "identified risks" is unnecessary because it is already mentioned in the requirement for determining significant risks. Accordingly, the definition of significant risk included in the reproposed standard is retained.

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

a. Background

Auditing Standard No. 13 establishes requirements for responding to the risks of material misstatement, including responses regarding the general conduct of the audit and responses involving audit procedures. Auditing Standard No. 13 applies to integrated audits and audits of financial statements only.

b. Linking Assessed Risks and Auditor's Responses

The reproposed standard included a requirement for the auditor to design and implement appropriate responses to the "assessed risks of material misstatement" to address comments received on the original proposed standard for improving the linkage between the auditor's responses and the identification and assessment of risks of material misstatement. Acknowledging the improvements in the reproposed standard, some commenters continued to suggest that the objective also should state that the auditor is to address the assessed risks of material misstatement.

In the Board's view, obtaining sufficient appropriate evidence to support the auditor's opinion requires the auditor to adequately respond to the risks of material misstatement. Accordingly, the title and objective of the standard continue to refer to responding to the risks of material misstatement. However, the Board recognizes that the appropriate identification and assessment of the risks of material misstatement in accordance with Auditing Standard No. 12 enable the auditor to effectively respond to the risks of material misstatement. Auditing Standard No. 13 continues to impose on auditors an unconditional responsibility to design and implement responses that address the risks of material misstatement identified and assessed in accordance with Auditing Standard No. 12.[305] As with the reproposed standard, noncompliance with the requirements in Auditing Standard No. 12 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 this standard.[306]

c. Overall Responses to Risks

The reproposed standard included a requirement for the auditor to respond to the risks of material misstatement through overall responses and responses involving the nature, timing, and extent of audit procedures. Overall responses relate to the general conduct of the audit, e.g., appropriately assigning and properly supervising engagement team members, incorporating an element of unpredictability into the audit, evaluating the company's selection and application of significant accounting principles, and making pervasive changes to the audit. Such responses are required by AU sec. 316 in response to fraud risks, but the reproposed standard extended the requirement to apply to risks of material misstatement due to error or fraud. These responses, by their nature, are appropriate for addressing risks of material misstatement due to error or fraud.

Some commenters expressed concerns regarding the expansion of the requirement for incorporating an

[299] Ibid.

[300] Paragraph 65 of Auditing Standard No. 12.

[301] Paragraph 66 of Auditing Standard No. 12.

[302] Paragraph 67 of Auditing Standard No. 12.

[303] Paragraph 68 of Auditing Standard No. 12.

[304] *See, e.g.,* Committee of Sponsoring Organizations of the Treadway Commission, *Fraudulent Financial Reporting: 1998–2007* (May 2010).

[305] Paragraph 3 of Auditing Standard No. 13.

[306] Failure to address a risk of material misstatement also might indicate a failure to comply with Auditing Standard No. 12.

element of unpredictability to apply to risks of material misstatement other than fraud risks.

In the Board's view, although incorporating an element of unpredictability is intended primarily to address fraud risks, it also can enable the auditor to detect errors or control deficiencies that could otherwise remain undetected. In addition, the requirement to incorporate an element of unpredictability when testing controls already exists in Auditing Standard No. 5. Auditing Standard No. 13 continues to indicate that the auditor should incorporate an element of unpredictability as part of the response to the risks of material misstatement, including fraud risks.[307]

One commenter requested clarification regarding the differences between the first and third examples used to illustrate ways to incorporate an element of unpredictability in paragraph 5.c. of the reproposed standard. The first example in Auditing Standard No. 13 is intended to illustrate that the auditor may decide to perform audit procedures for a particular account, disclosure, or assertion even though the auditor's risk assessment did not identify specific risks associated with those accounts.[308] The third example is intended to illustrate that when sampling a particular financial statement amount, the auditor may consider selecting items with amounts lower than the threshold that the auditor had used in the past, or expanding the selection to other sections of the population that the auditor had not tested in the past.[309]

The reproposed standard required the auditor to evaluate whether it is necessary to make pervasive changes to the audit to adequately address the assessed risks of material misstatement. The reproposed standard did not require that pervasive changes be made in every audit. Instead, it required the auditor to evaluate whether pervasive changes that affect many aspects of the audit are needed to address the assessed risks of material misstatement. Commenters questioned the use of the term "pervasive" in the requirement. Auditing Standard No. 13 provides additional explanation of the types of circumstances in which pervasive changes might be necessary.[310]

Existing PCAOB standards require the auditor to apply professional skepticism as part of due care,[311] and Auditing Standard No. 13 states that the auditor's response to fraud risks involves the application of professional skepticism in gathering and evaluating audit evidence.[312] The requirement is intended to emphasize the importance of professional skepticism in responding to risks of material misstatement without limiting its application to the auditor's responses.

One commenter expressed concern that the reproposed standard did not explicitly require the auditor to implement overall responses to risks at the financial statement level. Such an explicit requirement would inappropriately limit the auditor's overall responses to risks at the financial statement level. Many of the overall responses also apply to risks at the assertion level, *e.g.,* assigning more experienced personnel or applying a greater extent of supervision to accounts or disclosures with higher risk.

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

The reproposed standard required the auditor to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure. Auditing Standard No. 13 retained this requirement as reproposed. The requirement emphasizes that the auditor should focus on each relevant assertion of each significant account and disclosure and the risks of material misstatement associated with the relevant assertion when designing and performing audit procedures.

The reproposed standard also included requirements for the auditor to design the testing of controls to accomplish the objectives of both the audit of financial statements and the audit of internal control in an integrated audit. This requirement is aligned with Auditing Standard No. 5. One commenter suggested that that the requirement be removed because it relates only to integrated audits. The requirement was retained as reproposed because Auditing Standard No. 13 applies to integrated audits as well as audits of financial statements only, and tests of controls are a necessary response in the audit of internal control.[313]

e. Tests of Controls in an Audit of Internal Control

Auditing Standard No. 13 includes requirements for performing tests of controls in the audit of financial statements.[314]

In an integrated audit, the tests of controls performed in the audit of internal control are part of the auditor's responses to the risks of material misstatement, as indicated in paragraph 9–10 of Auditing Standard No. 13.[315] To help facilitate the integration of tests of controls in an integrated audit, the standard continues to use language similar to that of Auditing Standard No. 5 when describing analogous terms and concepts relating to the testing of controls.

f. Tests of Controls and Control Risk Assessment in the Audit of Financial Statements

(i). Requirements on When to Test Controls

AU sec. 319 required auditors to obtain evidence about the design effectiveness and operating effectiveness of controls (a) when the auditor plans to rely on selected controls to reduce his or her substantive procedures and (b) in those limited circumstances in which the auditor cannot obtain sufficient appropriate evidence through substantive procedures alone.[316] Thus, except in those limited circumstances, AU sec. 319 provided auditors with flexibility to decide when or whether to test controls.

Auditing Standard No. 13 does not change the requirements in AU sec. 319 regarding when testing controls is necessary in audits of financial statements only.[317] In those audits, auditors continue to have the same flexibility in deciding when or whether to test controls to reduce their substantive procedures.[318] Auditing Standard No. 13 includes additional statements that emphasize the flexibility that auditors have in making these decisions and provides additional examples, adapted from AU sec. 319.68, of situations in which auditors cannot obtain sufficient appropriate audit evidence through substantive procedures alone.[319]

[307] Paragraph 5.c. of Auditing Standard No. 13.

[308] Paragraph 5.c. (1) of Auditing Standard No. 13.

[309] Paragraph 5.c. (3) of Auditing Standard No. 13.

[310] Paragraph 6 of Auditing Standard No. 13.

[311] AU secs. 230.07–.09.

[312] Paragraph 7 of Auditing Standard No. 13.

[313] Paragraph 9.c. of Auditing Standard No. 13.

[314] Paragraphs 16–35 of Auditing Standard No. 13.

[315] Paragraph 39 of Auditing Standard No. 5 states, "The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion."

[316] AU sec. 319.66.

[317] Certain clarifying revisions were made to the discussion of relying on controls to modify the auditor's substantive procedures, in response to comments on the reproposed standard. *See* footnote 12 to paragraph 16 of Auditing Standard No. 13.

[318] Paragraph 16 of Auditing Standard No. 13.

[319] Paragraph 17 of Auditing Standard No. 13.

(ii). Period of Reliance

Auditing Standard No. 13 states that when the auditor relies on controls to assess control risk at less than the maximum, the auditor must obtain evidence that the controls selected for testing are designed effectively and operated effectively during the entire period of reliance.[320] The concept of the period of reliance was introduced in Auditing Standard No. 5 and discussed further in the PCAOB staff guidance, *Staff Views: An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements—Guidance for Auditors of Smaller Public Companies.* Auditing Standard No. 13 provides a definition of "period of reliance" that parallels the language in paragraph B4 of Auditing Standard No. 5.[321]

(iii). Evidence About the Effectiveness of Controls

Auditing Standard No. 13 describes the principle, adapted from AU sec. 319,[322] that the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. In applying that principle, Auditing Standard No. 13 requires the auditor to obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control. In addition, Auditing Standard No. 13 requires the auditor to obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls, including situations in which substantive procedures alone cannot provide sufficient appropriate audit evidence.[323]

(iv). Testing Operating Effectiveness

Auditing Standard No. 13 requires the auditor to determine, among other things, whether the person performing the control possesses the necessary authority and competence to perform the control effectively.[324] This requirement is intended to call to the auditor's attention that whether he or she possesses the appropriate level of authority and the knowledge and skills necessary to perform the control function is essential to whether a person can effectively perform the control. Thus, the auditor is required to make such determination before he or she can conclude about the effectiveness of the control.

(v). Timing of Tests of Controls—Evidence Obtained During an Interim Period

The reproposed standard stated that the auditor must obtain evidence about the effectiveness of controls selected for testing for the entire period of reliance. When the auditor tests controls during an interim period, additional evidence that is necessary concerning the operation of those controls for the remaining period of reliance depends on a series of factors listed in the reproposed standard, including, among other factors, the possibility of significant changes in internal control over financial reporting occurring subsequent to the interim date.

One commenter suggested adding "control environment" to the list of factors that could affect the auditor's determination of what additional evidence is necessary. The control environment has an important, but indirect, effect on the likelihood that a misstatement will be prevented or detected on a timely basis. Also, unlike monitoring controls, the control environment is not designed to identify possible breakdowns in other controls. Accordingly, the control environment, by itself, does not reduce the amount of evidence needed concerning controls over specific relevant assertions for the remaining period. The control environment is not included in the list of factors in Auditing Standard No. 13.

Another commenter suggested adding a requirement for the auditor to obtain, when applicable, audit evidence about subsequent changes to the controls tested during the interim period. A note has been added to Auditing Standard No. 13 requiring the auditor to obtain evidence about such subsequent changes, if significant.[325]

(vi). Timing of Tests of Controls—Evidence from Past Audits

Auditing Standard No. 13 states that the auditor should obtain evidence during the current year audit about the design and operating effectiveness of controls upon which the auditor relies.[326] This requirement is based on the principle that auditors should support their control risk assessments each year with current evidence. However, when the auditor has tested the controls in the past and plans to rely on the same controls for the current year audit, the amount of evidence needed will vary based on the relevant factors listed in the standard.[327] These additional factors generally relate to the degree of reliance on the control, the risk that the control will fail to operate as designed, and the nature and amount of evidence that the auditor has already obtained regarding the effectiveness of the controls. These requirements are consistent with Auditing Standard No. 5. Also, the standard allows the auditor to use a benchmarking strategy, when appropriate, for automated application controls for subsequent years' audits, as do the provisions of Auditing Standard No. 5. However, the standard does not permit testing controls once every third year because the standard requires evidence regarding the effectiveness of controls to be obtained each year.

Some commenters expressed concern that the requirements in the reproposed standard for determining the amount of evidence needed in the current year could be interpreted as requiring the auditor to consider each factor listed for each of the controls that the auditor tested in the past, regardless of whether or not the auditor plans to rely on those controls for purposes of the current year audit. The requirement was intended to apply when the auditor tested the controls in the past audits and plans to rely on those controls and use evidence about the effectiveness of those controls obtained in prior years for purposes of the current year audit. That requirement is clarified in Auditing Standard No. 13.[328]

(vii). Assessing Control Risk

Auditing Standard No. 13 requires the auditor to assess control risk for relevant assertions.[329] This requirement is not new. AU sec. 319 established requirements for the auditor to assess control risk, and Auditing Standard No. 5 discusses control risk assessment in the financial statement audit portion of the integrated audit.[330]

Auditing Standard No. 13 requires the auditor to assess the control risk at the maximum level for relevant assertions when the controls necessary to sufficiently address the assessed risk of material misstatement in those assertions are missing or ineffective or when the auditor has not obtained sufficient appropriate evidence to support a control risk assessment below the maximum level.[331]

One commenter expressed a concern that the reproposed standard seemed to

[320] Paragraph 16 of Auditing Standard No. 13.

[321] Paragraph A.3 of Auditing Standard No. 13.

[322] AU sec. 319.90.

[323] Paragraph 18 of Auditing Standard No. 13.

[324] Paragraph 21 of Auditing Standard No. 13.

[325] Paragraph 30 of Auditing Standard No. 13.

[326] Paragraph 31 of Auditing Standard No. 13.

[327] Ibid.

[328] Ibid.

[329] Paragraphs 32–34 of Auditing Standard No. 13.

[330] AU secs. 319.70, .83-.90 and paragraphs B4–B5 of Auditing Standards No. 5.

[331] Paragraph 33 of Auditing Standard No. 13.

indicate that no reduction of the control risk assessment should occur based on understanding the design effectiveness of controls. The commenter suggested that a control that does not exist or is not designed effectively should have a different impact on the auditor's testing than a control that is designed effectively but not tested by the auditor.

The risk assessment standards already address the points raised by the commenter regarding the effect of control deficiencies on the auditor's testing. Auditing Standard No. 12 requires the auditor to obtain an understanding of the design of the company's controls as part of his or her risk assessment procedures.[332] If the auditor identifies design deficiencies in the company's controls, the auditor would take that into account in identifying and assessing the risks of material misstatement, and Auditing Standard No. 13 requires the auditor to implement responses to address those risks of material misstatement. When deficiencies are detected during the auditor's testing of controls that the auditor plans to rely on, Auditing Standard No. 13 requires the auditor to (1) perform tests of other controls related to the same assertion as the ineffective controls, or (2) revise the control risk assessment and modify the planned substantive procedures as necessary in light of the increased assessment of risk.[333]

Another commenter suggested that the reproposed standard provide more direction about evaluating control deviations by adding a paragraph from Auditing Standard No. 5 regarding evaluating control deficiencies. The referenced paragraph does not apply specifically to assessing control risk in a financial statement audit, and Auditing Standard No. 13 requires the auditor to evaluate the evidence from all sources, including the results of test of controls, when assessing control risk for relevant assertions.[334]

g. Substantive Procedures

Auditing Standard No. 13 requires the auditor to perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk.[335] By definition, a relevant assertion of a significant account and disclosure has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated.[336] The requirement to obtain evidence from substantive procedures for each relevant assertion of each significant account and disclosure reflects the principle that the auditors need to implement appropriate responses to address the assessed risks of material misstatement.

Existing PCAOB standards indicate that some risks of material misstatement might require more evidence from substantive procedures because of certain inherent limitations of internal control.[337] For example, more evidence from substantive procedures ordinarily is needed for relevant assertions that have a higher susceptibility to management override or to lapses in judgment or breakdowns resulting from human failures. Observations from the Board's oversight activities have underscored the importance of this principle. Auditing Standard No. 13 includes this principle because it is particularly relevant to the determination of the nature, timing, and extent of substantive procedures. It is also consistent with the principles regarding detection risk discussed in Auditing Standard No. 8.

h. Timing of Substantive Procedures

The reproposed standard included a requirement for the auditor to take into account certain factors in determining whether it is appropriate to perform substantive procedures at an interim date. One commenter suggested that another point be added to the standard to require the auditor to review "the internal control changes that have been made to date and the nature and extent of monitoring such changes by the client staff." Auditing Standard No. 13 requires the auditor to consider the effect of known or expected changes in the company, its environment, and its internal control over financial reporting during the remaining period on its risk assessments when determining whether to perform substantive procedures at an interim date.[338] This additional requirement recognizes that both changes in controls and other changes to the company and its environment can affect the risks of material misstatement and, thus, the effectiveness of interim substantive procedures. For example, significant changes in industry or market conditions near year end could increase the risk of material misstatement regarding the valuation of assets at year end, which, in turn, would require significant audit attention during the remaining period.

The reproposed standard stated that when an auditor performs substantive procedures as of an interim date, the auditor should perform 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. The reproposed standard also required that the auditor perform certain procedures that were adapted from AU sec. 313.

Some commenters suggested that the Board remove the mandatory procedures in the reproposed standard, arguing that the procedures should be determined by the auditor based on professional judgment. Removing those requirements as suggested by the commenters would weaken PCAOB standards. Observations from the Board's oversight activities have included instances in which inadequate audit work was performed when extending the conclusion reached at the interim date to the end of the period covered by the financial statements. Therefore, retaining the mandatory procedures in this standard continues to be appropriate.[339]

i. Substantive Procedures Responsive to Significant Risks

Like the original proposed standard, the reproposed standard stated that the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the significant risks. AU sec. 329 indicates that tests of details should be performed in response to significant risks.[340]

One commenter continued to express concern about imposing a presumptively mandatory responsibility for auditors to perform tests of details in response to significant risks. Auditing Standard No. 13 retains the requirement as reproposed.[341] The nature and importance of significant risks warrant a high level of assurance from substantive procedures to adequately address the risk. Also, analytical procedures alone are not well suited to detecting certain types of misstatements related to significant risks, including, in particular, fraud risks. For example, when fraud risks are present, management might be able to override controls to allow adjustments that result in artificial changes to the financial statement relationships being analyzed,

[332] Paragraph 20 of Auditing Standard No. 12.

[333] Paragraph 34 of Auditing Standard No. 13.

[334] Paragraph 32 of Auditing Standard No. 13.

[335] Paragraph 36 of Auditing Standard No. 13.

[336] Paragraph A9 of Auditing Standard No. 5.

[337] *See, e.g.,* paragraph .14 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures.*

[338] Paragraph 44.a.(3) of Auditing Standard No. 13.

[339] Paragraph 45 of Auditing Standard No. 13.

[340] AU sec. 329.09.

[341] Paragraph 11 of Auditing Standard No. 13.

causing the auditor to draw erroneous conclusions.

j. Dual-purpose Test

Auditing Standard No. 13 recognized that, in certain situations, the auditor might perform a substantive test of a transaction concurrently with a test of a control relevant to that transaction, *i.e.,* a dual-purpose test. The auditor is required to design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. In addition, the auditor is required to evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested.[342] The standard refers the auditors to the relevant requirements in AU sec. 350, *Audit Sampling,* for determining the proper sample size in a dual-purpose test.

9. Auditing Standard No. 14—Evaluating Audit Results

a. Background

Auditing Standard No. 14 describes the auditor's responsibilities regarding the process of evaluating the results of the audit and determining whether sufficient appropriate audit evidence has been obtained in order to form the opinion to be expressed in the auditor's report. This standard consolidates into one auditing standard the requirements that were previously included in five separate auditing standards.[343] The standard highlights matters that are important to the auditor's conclusions about the financial statements and the effectiveness of internal control.

b. Definition of Misstatement

The reproposed standard defined the term "misstatement" as follows:

A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework.[344] A misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework. Misstatements can arise from error (i.e., unintentional misstatement) or fraud.

Some commenters indicated that the definition applied to "material misstatement" rather than "misstatement" and suggested revisions to the definition, e.g., moving the second sentence to the beginning of the definition.

Auditing Standard No. 14 carries forward the definition of "misstatement" as reproposed.[345] This definition is not a definition of the term "material misstatement." Rather, the definition emphasizes that misstatements prevent financial statements from being fairly presented in conformity with the applicable financial reporting framework, as discussed in AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.* The phrase used in the definition, "if material individually or in combination with other misstatements," is equivalent to the phrase "In the absence of materiality considerations," which was used in the description of the term "misstatement" in an auditing interpretation of AU sec. 312.[346] The second sentence of the definition in Auditing Standard No. 14 describes the most common types of misstatements.[347]

c. Performing Analytical Procedures in the Overall Review

Auditing Standard No. 14 adapted the requirements that were previously included in AU secs. 316 and 329 to read the financial statements and disclosures and perform analytical procedures in the overall review. The standard imposes on auditors a responsibility to read the financial statements and disclosures and perform analytical procedures to (a) evaluate the auditor's conclusions formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement.[348] In particular, Auditing Standard No. 14 requires the auditor to evaluate whether (a) evidence gathered in response to unusual or unexpected transactions, events, amounts, or relationships previously identified during the audit is sufficient and (b) unusual or unexpected transactions, events, amounts, or relationships indicate risks of material misstatement that were not identified previously.[349] Performing analytical procedures in the overall review assists the auditor in assessing the conclusions reached and in evaluating the overall financial statement presentation.

Auditing Standard No. 14 adapted a requirement, which previously existed in AU sec. 316, for the auditor to perform analytical procedures relating to revenue through the end of the period.[350] These procedures are intended to identify unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including a material misstatement due to fraud. Performing analytical procedures relating to revenue is important in light of the generally higher risk of financial statement fraud involving revenue accounts.

Auditing Standard No. 14 requires the auditor to corroborate management's explanations regarding significant unusual or unexpected transactions, events, amounts, or relationships. The standard also states that if management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures to address the matter.[351] Auditing Standard No. 15, *Audit Evidence,* states that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level.[352] Therefore, obtaining corroboration of management's responses is important in obtaining sufficient appropriate audit evidence.

d. Clearly Trivial

Auditing Standard No. 14 requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial.[353] Like AU sec. 312, the standard allows the auditor to set a threshold for accumulating misstatements, provided that the threshold is set at a de minimis level that could not result in material misstatement of the financial statements, individually or in combination with other misstatements, after considering the possibility of

[342] Paragraph 47 of Auditing Standard No. 13.

[343] 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. 326, regarding determining whether sufficient appropriate audit evidence has been obtained; and AU sec. 431, regarding the evaluation of disclosures.

[344] 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.

[345] Paragraph A2 of Appendix A to Auditing Standard No. 14.

[346] Paragraph .02 of AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312,* which is superseded by the risk assessment standards, stated "In the absence of materiality considerations, a misstatement causes the financial statements not to be in conformity with generally accepted accounting principles."

[347] *See also* paragraph A2 of Auditing Standard No. 14.

[348] Paragraph 5 of Auditing Standard No. 14.

[349] Paragraph 6 of Auditing Standard No. 14.

[350] Paragraph 7 of Auditing Standard No. 14.

[351] Paragraph 8 of Auditing Standard No. 14.

[352] Paragraph 17 of Auditing Standard No. 15.

[353] Paragraph 10 of Auditing Standard No. 14.

further undetected misstatement.[354] The specific limitation on setting a threshold for accumulating misstatements is important to assure a proper evaluation of the effect of uncorrected misstatements on the financial statements.

e. Accumulating Misstatements

The reproposed standard required the auditor to accumulate identified misstatements other than those that are clearly trivial. The reproposed standard also required the auditor to use his or her best estimate of the total misstatement in the accounts and disclosures that the auditor has tested, not just the amount of misstatements specifically identified. This includes misstatements related to accounting estimates and projected misstatements from substantive procedures that involve audit sampling.[355]

Commenters suggested that the standard should use terms such as "known and likely misstatement" or other terms to categorize the misstatements. Auditing Standard No. 14 uses the term "identified misstatement" to refer to misstatements that are identified during the audit and the term "accumulated misstatements" to refer to misstatements that are more than clearly trivial and, thus, should be accumulated by the auditor. Because Auditing Standard No. 14 requires the auditor to use his or her best estimate of the misstatements (which is how AU sec. 312 described "likely misstatements"), it is not necessary to use the term "known and likely misstatements."

f. Correction of Misstatements

Auditing Standard No. 14 requires that if management made corrections to accounts or disclosures in response to misstatements detected by the auditor, the auditor should evaluate management's work to determine whether the corrections have been recorded properly and to determine whether uncorrected misstatements remain.[356] The standard imposes on auditors a responsibility to determine whether misstatements identified by the auditor and communicated to management are correctly recorded in the accounting records.

g. Considerations When Accumulated Misstatements Approach the Materiality Level or Levels Used in Planning and Performing Audit Procedures

Auditing Standard No. 14 requires the auditor to determine whether the overall strategy needs to be revised when the aggregate of misstatements accumulated during the audit approaches the materiality level or levels used in planning and performing the audit. When the aggregate of misstatements approaches the materiality level or levels used in planning and performing an audit, there likely will be greater than an appropriately low level of risk that possible undetected misstatements, combined with uncorrected misstatements accumulated during the audit, could be material to the financial statements. If the auditor assesses this risk to be unacceptably high, he or she should perform additional audit procedures or determine that management has adjusted the financial statements so that the risk that the financial statements are materially misstated has been reduced to an appropriately low level.[357]

The reproposed standard stated that when the aggregate of accumulated misstatements approaches the materiality used in planning and performing the audit, the auditor should perform additional procedures or determine that management has adjusted the financial statements so that the risk of material misstatement has been reduced to an appropriately low level. One commenter suggested that it is not clear what the additional procedures are and that more work is not always the answer. The additional procedures that are necessary depend upon, among other things, the procedures performed by the auditor to date and the nature of the misstatements that were detected.

h. Requirement to Reevaluate the Materiality Level

Auditing Standard No. 11 includes a requirement to reevaluate the established materiality level or levels in certain circumstances. Auditing Standard No. 14 states that if the reevaluation of the materiality level or levels established in accordance with Auditing Standard No. 11 results in a lower amount for the materiality level or levels, the auditor should take into account that lower materiality level in the evaluation of uncorrected misstatements.[358] The requirements are intended to prevent the auditor from incorrectly concluding that uncorrected misstatements are immaterial because he or she used outdated financial statement information. However, the standard does not allow the auditor to establish a higher level or levels of materiality when uncorrected misstatements exceed the initially established level or levels of materiality.

Reevaluating the established materiality level or levels prior to evaluating the effect of uncorrected misstatements will cause audit results to be evaluated based on the latest financial information.

i. Evaluating Uncorrected Misstatements

The reproposed standard stated that the auditor should evaluate the uncorrected misstatements in relation to accounts and disclosures and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors. The reproposed standard retained the provisions regarding qualitative factors that were included in an auditing interpretation to AU sec. 312,[359] with some minor revisions to align the factors more closely to the terminology in the reproposed standard and to omit qualitative factors that apply only to nonissuers. A commenter indicated that the term "profitability," which is included in the qualitative factors in Appendix B, is not defined, and the commenter suggested including examples of profitability in the reproposed standard. Although this term is not explicitly defined in Auditing Standard No. 14, it should be familiar to auditors because the related auditing interpretation was issued in 2000. Auditing Standard No. 14 carries forward the requirements and the related list of qualitative factors that are substantially the same as those in the auditing interpretation.[360]

Auditing Standard No. 14 requires an evaluation of the effects of both uncorrected misstatements detected in prior years and misstatements detected in the current year that relate to prior years.[361] The standard does not address how to evaluate the effects of prior period misstatements because that is an accounting and financial reporting matter. For example, the SEC staff has provided guidance in SEC Staff Accounting Bulletin ("SAB") Topic 1.N, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements,* on the effects of prior year misstatements when quantifying

[354] Paragraph 11 of Auditing Standard No. 14.

[355] Paragraphs 10–12 of Auditing Standard No. 14.

[356] Paragraph 16 of Auditing Standard No. 14.

[357] Paragraph 14 of Auditing Standard No. 14.

[358] Paragraph 17 of Auditing Standard No. 14.

[359] AU sec. 9312.15–17.

[360] AU sec. 9312 and paragraph 17 and Appendix B of Auditing Standard No. 14.

[361] Paragraph 18 of Auditing Standard No. 14.

misstatements in the current year financial statements. This SAB provides the SEC staff's views regarding evaluating the quantitative and qualitative factors regarding the materiality of uncorrected misstatements and evaluating the effects of prior year misstatements.

Auditing Standard No. 14 states that the auditor cannot assume that an instance of error or fraud is an isolated occurrence and that the auditor should evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement.[362] This procedure is important to inform the auditor's conclusions about whether the auditor's risk assessments remain appropriate and whether he or she has obtained sufficient appropriate evidence to support his or her opinion.

The reproposed standard included a requirement to evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement. A commenter suggested that this evaluation should be performed at the time the misstatement is identified. In the Board's view, it is not necessary to prescribe the timing for the evaluation of the nature and effects of misstatements on the risk assessments. However, performing this evaluation during the course of the audit could allow the auditor to make the necessary modifications to his or her planned audit procedures on a more timely basis.

The reproposed standard required the auditor to evaluate whether identified misstatements might be indicative of fraud and, in turn, how they affect the auditor's evaluation of materiality and the related audit responses. This requirement is adapted from AU sec. 316.[363] One commenter suggested that when there is an indicator of fraud, the requirement should make clear that clearly trivial misstatements may need to be evaluated to determine if they should be included in the accumulated misstatements. Like AU sec. 316, the requirement in the reproposed standard was phrased in terms of identified misstatements rather than accumulated misstatements because fraud of relatively small amounts can be material to the financial statements.

Auditing Standard No. 14 retains the requirement as reproposed.[364] If an auditor detects a misstatement, he or she should evaluate whether the misstatement is indicative of fraud when deciding whether a misstatement is clearly trivial and thus does not warrant being included with accumulated misstatements. Additionally, in situations in which the auditor believes that a misstatement is or might be intentional and the effect on the financial statements could be material or cannot be readily determined, Auditing Standard No. 14 requires that the auditor perform procedures to obtain additional audit evidence to determine whether the fraud has occurred or is likely to have occurred. If the fraud has occurred or is likely to have occurred, the auditor is required to determine its effect on the financial statements and the auditor's report thereon.

j. Communication of Accumulated Misstatements to Management

The reproposed standard required the auditor to communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them. The reproposed standard also required the auditor to obtain an understanding of the reasons that management decided not to correct misstatements communicated by the auditor.

Some commenters suggested that the standard should specifically require the auditor to request management to correct the misstatements.

Auditing Standard No. 14 retains the requirement as reproposed.[365] It is not necessary to specifically require the auditor to request that management correct the misstatements because management has its own legal responsibilities in relation to the preparation and maintenance of the company's books, records, and financial statements. Section 13(i) of the Securities and Exchange Act of 1934, 15 U.S.C. 78m(i), requires the financial statements filed with the SEC to reflect all material correcting adjustments identified by the auditor.

k. Communication of Illegal Acts

Auditing Standard No. 14 requires the auditor to determine his or her responsibility under AU secs. 316.79–.82A, AU sec. 317, and Section 10A of the Securities and Exchange Act of 1934, 15 U.S.C. 78j–1, if the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred.[366]

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

Auditing Standard No. 14 requires the auditor to evaluate the qualitative aspects of the company's accounting practices, including potential bias in management's judgments regarding the amounts and disclosures in the financial statements.[367]

Auditing Standard No. 14 also states that if the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, the auditor should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. Also, the standard states that the auditor should evaluate whether the auditor's risk assessments, including, in particular, the assessment of fraud risks, and the related audit responses remain appropriate.[368]

The reproposed standard included an example of management bias, which was based on observations from the Board's oversight activities. This example indicated that when management identifies adjusting entries that offset misstatements identified by the auditor, the auditor should perform procedures to determine why the underlying misstatement was not identified previously. The auditor also should evaluate the implications on the integrity of management, and the auditor's risk assessments, including fraud risk assessments, and perform additional procedures as necessary to address the risk of further undetected misstatements. A commenter suggested using the phrase "identified misstatements other than those that are * * * clearly trivial" instead of "identified misstatements." The requirement has been revised to refer to misstatements accumulated by the auditor as required by paragraph 10 of Auditing Standard No. 14.[369]

m. Assessment of Fraud Risks

The reproposed standard required the auditor to evaluate whether the accumulated results of auditing procedures and other observations affect the auditor's assessment of fraud risks made throughout the audit and whether the audit procedures need to be modified to respond to those risks.[370] The reproposed standard included a reference to Appendix C, which listed matters that might affect the assessment of fraud risks. Appendix C stated that if

[362] Paragraph 19 of Auditing Standard No. 14.

[363] AU sec. 316.75.

[364] Paragraph 20 of Auditing Standard No. 14.

[365] Paragraphs 15 and 25 of Auditing Standard No. 14.

[366] Paragraph 23 of Auditing Standard No. 14.

[367] Paragraph 24 of Auditing Standard No. 14.

[368] Paragraph 26 of Auditing Standard No. 14.

[369] Paragraph 25 of Auditing Standard No. 14.

[370] Paragraph 28 of Auditing Standard No. 14.

the matters listed in the appendix are identified during the audit, the auditor should determine whether the assessment of fraud risks remains appropriate or needs to be revised. This requirement was included because the evaluation provides additional insight regarding the fraud risks and the potential need to perform additional procedures to support the opinion to be expressed in the auditor's report.

Some commenters indicated that the requirement in Appendix C seems to indicate that the auditor is required to determine if each item identified during the audit individually affects the assessment of fraud risks, which appears to be inconsistent with paragraph 28. Those commenters suggested revisions to the first sentence of Appendix C. After considering these comments, the first sentence of Appendix C has been revised to state that if the matters listed in the appendix are identified during the audit, the auditor should take into account these matters in the evaluation of the assessment of fraud risks, as discussed in paragraph 28.[371]

One commenter suggested including in Appendix C specific procedures that the auditor could perform to evaluate fraud risk, such as evaluating journal entries with round numbers or amounts slightly below a specified threshold. This type of procedure could be appropriate for selecting journal entries for testing, but it is different in nature from the matters listed in Appendix C.

Auditing Standard No. 14 includes a requirement for the engagement partner to determine whether there has been appropriate communication with the other engagement team members throughout the audit regarding information or conditions that are indicative of fraud risks.[372] This requirement is adapted from the existing PCAOB standards.[373]

n. Evaluating Financial Statement Disclosures

The reproposed standard included a requirement, adapted from AU sec. 431, for the auditor to evaluate whether the financial statements contain the required disclosures and, if the required disclosures are not included in the financial statements, to express a qualified or adverse opinion in accordance with AU sec. 508, *Reports on Audited Financial Statements.* The reproposed standard also stated that evaluation of disclosures includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth. These requirements were included in the reproposed standard because of the importance of disclosures to the fair presentation of financial statements.

Some commenters stated that the requirements regarding evaluation of disclosures should be qualified based on materiality considerations. Auditing Standard No. 14 states that the auditor should evaluate whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework, which is aligned with an analogous requirement in AU sec. 508.41.[374] AU sec. 411 discusses the concept of materiality regarding the auditor's opinion that financial statements are presented fairly.[375]

Another commenter questioned whether the statement that "Evaluation of disclosures includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth" is a requirement. The statement in the reproposed standard, which is retained in Auditing Standard No. 14, explains that the scope of the auditor's required evaluation of the information disclosed in the financial statements includes matters such as the form, arrangement, and content of the financial statements.[376]

o. Evaluating the Sufficiency and Appropriateness of Audit Evidence

The reproposed standard required the auditor to conclude whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements. The reproposed standard also presented a list of factors that are relevant to the auditor's conclusion on whether sufficient appropriate audit evidence has been obtained. Consideration of the listed factors is essential to reaching an informed conclusion about whether sufficient appropriate audit evidence has been obtained. Accordingly, both the requirement and the list of factors contained in the reproposed standard have been retained.[377]

A commenter suggested that corrected adjustments also should be considered in concluding whether sufficient appropriate audit evidence has been obtained. Auditing Standard No. 14 already requires the auditor to evaluate the results of audit procedures in evaluating whether sufficient appropriate evidence has been obtained, and this would include misstatements identified by the auditor, regardless of whether they were corrected by management.[378]

The reproposed standard expanded the requirements regarding situations in which the auditor has not obtained sufficient appropriate audit evidence to include situations in which the auditor has substantial doubt about a relevant assertion. This additional provision was adapted from AU sec. 326. A commenter suggested that the requirement be revised to state that the auditor should attempt to obtain additional evidence if the auditor has not obtained sufficient appropriate evidence about a relevant assertion. The requirement has been retained as stated in the reproposed standard because it covers situations in which the evidence is inadequate and situations in which the auditor has concerns about whether an assertion is misstated.[379]

p. Evaluating the Results of the Audit of Internal Control

The reproposed standard included a section relating to evaluating audit results in the audit of internal control, which references Auditing Standard No. 5 for the requirements on evaluating the results of the audit of internal control.[380] A commenter suggested removing this paragraph from the reproposed standard. Auditing Standard No. 14 retains this paragraph, although it does not impose additional requirements. Including this paragraph emphasizes that, in integrated audits, the evaluation of audit results is an integrated process that affects both audits.

10. Auditing Standard No. 15—Audit Evidence

a. Background

Auditing Standard No. 15 explains what constitutes audit evidence, establishes requirements regarding designing and performing audit procedures to obtain sufficient

[371] Paragraph C1 of Appendix C to Auditing Standard No. 14.

[372] Paragraph 29 of Auditing Standard No. 14.

[373] AU sec. 316.18.

[374] Paragraph 31 of Auditing Standard No. 14.

[375] AU sec. 411.04.

[376] Paragraph 31 of Auditing Standard No. 14.

[377] Paragraphs 33–34 of Auditing Standard No. 14.

[378] Paragraph 34 of Auditing Standard No. 14.

[379] Paragraph 35 of Auditing Standard No. 14.

[380] Paragraph 37 of Auditing Standard No. 14.

appropriate audit evidence to support the opinion in the auditor's report, and discusses methods for selecting items for testing.

b. Nature of Audit Evidence

The reproposed standard stated that 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 auditor's 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.

One commenter indicated that the meaning of the phrase "and any information that contradicts such assertions" was unclear. The commenter suggested that the Board clarify whether the requirement meant the auditor should look for such contradictory information, or if the requirement should apply only when such information comes to the auditor's attention.

PCAOB standards require the auditor to plan and perform the audit to obtain sufficient appropriate evidence to support an opinion about whether the financial statements are free of material misstatement and, in the audit of internal control, whether material weaknesses exist.[381] Thus, the auditor is required to perform the audit procedures necessary to test the accounts and controls, regardless of whether the results of those procedures support or contradict the assertions. The requirement in Auditing Standard No. 15 means that when contradictory evidence is obtained, the auditor should evaluate it when forming a conclusion on the financial statements and, in integrated audits, on internal control over financial reporting. To clarify the requirement, Auditing Standard No. 15 omits the word "any."[382]

c. Objective

The objective in the reproposed standard acknowledged the auditor's responsibility to plan and perform the audit to obtain sufficient appropriate audit evidence to support the opinion expressed in the auditor's report. Commenters suggested revising the wording in paragraph 4 of the reproposed standard to be consistent with the objective in paragraph 3 of the reproposed standard. The requirement in paragraph 4 of Auditing Standard No. 15 has been revised to be consistent with the objective of the standard.

d. Sufficient Appropriate Audit Evidence

The reproposed standard explained the meaning of the words "sufficient" and "appropriate" as used in the phrase "sufficient appropriate audit evidence." Commenters suggested that the Board provide formal definitions for terms like "sufficiency" and "appropriate" so the terms can be easily located within the standards. Adding definitions is unnecessary because Auditing Standard No. 15 already describes the terms "sufficiency" and "appropriateness" and explains the relevant characteristics of each.[383]

Commenters stated that the term "persuasive" was used in the reproposed standard, *The Auditor's Responses to the Risks of Material Misstatement,* and recommended that the Board clarify in the reproposed audit evidence standard the manner in which the persuasiveness of evidence affects the evaluation of audit evidence. The concept of "persuasiveness of evidence" is discussed in Auditing Standard No. 13.[384]

e. Relevance and Reliability

The reproposed standard contained a discussion about the relevance and reliability of audit evidence. The reproposed standard stated that the audit evidence must be both relevant and reliable to support the auditor's conclusions about the subject of the audit procedure. The reproposed standard stated that "[e]vidence 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."

One commenter suggested that the standard be revised to indicate that electronic information, subject to proper controls, is in many ways more reliable than physical documentation. The language from the reproposed standard was retained in Auditing Standard No. 15.[385] Although evidence sometimes is available only in electronic form and the reliability of electronic evidence depends on the controls over that information, an authentic original document generally is more reliable than an electronic form of that document.

The reproposed standard stated that 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, and (b) the timing of the audit procedure used to test the assertion or control. One commenter recommended the description of the term "relevance" should be expanded to include the following statements:

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

Auditing Standard No. 15 retains the description included in the reproposed standard because it is clearer than the suggested revision.[386]

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

One commenter suggested that the requirement for the auditor to modify the planned audit procedures or perform additional audit procedures in response to concerns about the authenticity of documents should be linked to professional skepticism. The commenter also stated that many modifications are routine. The requirement was not meant to require the auditor to perform unlimited procedures but, rather, to perform the procedures necessary to address the issue in the circumstances. Auditing Standard No. 15 retains this requirement as reproposed.[387]Although professional skepticism is important in these situations, it is not the only factor that determines the procedures necessary to address the matter.

f. Financial Statement Assertions

In representing that the financial statements are presented fairly in conformity with the applicable financial reporting framework, management

[381] Paragraph 3 of Auditing Standard No. 8 and paragraph 3 of Auditing Standard No. 5, respectively.

[382] Paragraph 2 of Auditing Standard No. 15.

[383] Paragraphs 5–6 of Auditing Standard No. 15.

[384] Paragraph 39 of Auditing Standard No. 13.

[385] Paragraph 8 of Auditing Standard No. 15.

[386] Paragraph 7 of Auditing Standard No. 15.

[387] Paragraph 9 of Auditing Standard No. 15.

implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of financial statements and related disclosures. Financial statement assertions are an important consideration for audits performed in accordance with PCAOB standards. For example, AU sec. 319 required auditors to perform substantive procedures for relevant assertions in audits of financial statements. Auditing Standard No. 5 requires auditors to obtain evidence about the design and operating effectiveness of controls over relevant assertions in audits of internal control.

The reproposed standard retained the five categories of financial statement assertions in AU sec. 326 and Auditing Standard No. 5. Two commenters suggested that the Board use different descriptions for financial statement assertions. One commenter suggested using other standard-setters' descriptions of financial statement assertions. The other commenter suggested using a different description of assertions. Auditing Standard No. 15 retains the categories of assertions as reproposed.[388] Like Auditing Standard No. 5,[389]Auditing Standard No. 15 allows auditors the flexibility to use categories of assertions that differ from the assertions listed in the standard under specified conditions.[390]

g. Inquiry

The reproposed standard stated that inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control. One commenter suggested that the note to paragraph 17 of the reproposed standard be revised to include "design and operating effectiveness of a control" and that the auditor should perform audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Auditing Standard No. 15 retains the language from the reproposed standard. The phrase "effectiveness of a control" encompasses both design and operating effectiveness. It is not considered necessary to add that the auditor should perform additional procedures, since Auditing Standard No. 15 states that inquiry, by itself, does not provide sufficient audit evidence.[391]

[388] Paragraph 11 of Auditing Standard No. 15.

[389] *See* the note to paragraph 28 of Auditing Standard No. 5.

[390] Paragraph 12 of Auditing Standard No. 15.

[391] Paragraph 17 of Auditing Standard No. 15.

h. Confirmation

The reproposed standard stated that a confirmation represents audit evidence obtained by the auditor as a direct response to the auditor from a third party. Some commenters suggested that the reproposed standard clarify that a confirmation be written. Auditing Standard No. 15 has been revised to state that a confirmation response represents a particular form of audit evidence obtained by the auditor from a third party in accordance with PCAOB standards.[392] The Board has a separate standards-setting project on confirmations that, among other things, will address the use of written confirmation or other alternative forms of confirmation.[393]

i. Analytical Procedures

The reproposed standard described analytical procedures as an audit procedure for obtaining evidence. One commenter suggested adding "scanning" as part of analytical procedures. Scanning is a means for selecting items for testing, not a separate audit procedure. The description of analytical procedures in Auditing Standard No. 15 is retained as reproposed.[394]

j. Selecting Items for Testing To Obtain Audit Evidence

Auditing Standard No. 15 contains a section on selecting items for testing that is adapted from an auditing interpretation of AU sec. 350.[395] The standard also states that the auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure.[396]

The reproposed standard defined audit sampling as 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. One commenter stated that the definition in the standard should be conformed to AU sec. 350. Auditing Standard No. 15 reflects revisions that align the standard with AU sec. 350.

k. Other Changes

As noted in the reproposing release, certain topics that were included in AU sec. 326 were not carried forward to the reproposed standard and Auditing Standard No. 15. AU sec. 326 discussed the use of audit objectives, and an appendix to that standard illustrated 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 discussion would not preclude auditors from using audit objectives in designing their audit procedures.

[392] Paragraph 18 of Auditing Standard No. 15.

[393] PCAOB Release No. 2010–003, *Proposed Auditing Standard Related to Confirmation and Related Amendments to PCAOB Standards* (July 13, 2010).

[394] Paragraph 21 of Auditing Standard No. 15.

[395] AU sec. 9350, *Audit Sampling: Auditing Interpretations of AU sec. 350.*

[396] Paragraph 22 of Auditing Standard No. 15.

11. Amendments to PCAOB Standards

a. Amendments to Auditing Standard No. 3

In the release accompanying the original proposed standards, the Board sought comment on the need for specific documentation requirements regarding the risk assessment procedures. Responses from commenters were mixed. Some commenters supported adding specific documentation requirements, other commenters stated that the requirements in Auditing Standard No. 3, *Audit Documentation,* were adequate, and one commenter was ambivalent.

After consideration of these comments and additional analysis, the amendments accompanying the reproposed standards included certain amendments to Auditing Standard No. 3 to (a) specify certain required documentation regarding the auditor's risk assessments and related responses, (b) align certain terms and provisions of Auditing Standard No. 3 with the risk assessment standards, and (c) incorporate the principles for documentation of disagreements among engagement team members. For example, the amendments indicated that the auditor's documentation should include the following:

• A summary of the identified risks of misstatement and the auditor's assessment of risks of material misstatement at the financial statement and assertion levels; and

• The auditor's responses to the risks of material misstatement, including linkage of the responses to those risks.

Also, the requirements regarding documentation of significant findings or issues and related matters were expanded to require documentation regarding the significant risks identified and the results of the auditing procedures performed in response to those risks.

A commenter indicated that the additional documentation requirement will result in "unnecessary linkage" and "a matrix-like mentality" to the audit documentation. The documentation requirements are intended to enhance the auditor's ability to link identified and assessed risks to appropriate responses and could help reviewers understand the areas of greatest risk and the auditor's responses to those risks. In addition to these documentation requirements, the auditor would continue to be responsible for preparing documentation as required by other provisions of Auditing Standard No. 3, e.g., to demonstrate that the engagement complied with the standards of the PCAOB.[397]

Some commenters suggested placing the documentation requirements in the respective risk assessment standards rather than amending Auditing Standard No. 3. The risk assessment standards are foundational standards; therefore, the required documentation related to the risk assessment standards is included in Auditing Standard No. 3.[398] Future decisions about the placement of new documentation requirements will be made during the course of the respective standards-setting projects.

b. Amendments to Auditing Standard No. 4

The amendment to Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues To Exist,* is limited to changing the word "competent" to "appropriate" when that word is used in reference to audit evidence.

c. Amendments to Auditing Standard No. 5

The amendments to Auditing Standard No. 5 that accompanied the reproposed standards were limited to changing the phrase "any assistants" to "the members of the engagement team," changing the word "competent" to "appropriate" when that word is used in reference to audit evidence, and updating references to auditing standards that are being superseded or amended. These amendments are retained as reproposed.

One commenter suggested a series of additional amendments to Auditing Standard No. 5, which primarily involved removing certain paragraphs from Auditing Standard No. 5 that relate to risk assessment procedures or other requirements that are included in the risk assessment standards. The Board is not removing the requirements regarding risk assessment procedures from Auditing Standard No. 5 because those requirements are important to understanding the other provisions of Auditing Standard No. 5 for performing an audit of internal control.

[397] Paragraph 5.a. of Auditing Standard No. 3.

[398] Paragraphs 9, 12, and 19 of Auditing Standard No. 3, as amended.

d. Amendments to Auditing Standard No. 6

The amendments to Auditing Standard No. 6, *Evaluating Consistency of Financial Statements,* are limited to removing a footnote stating that the term "error" as used in Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("SFAS No. 154"), is equivalent to "misstatement" as used in the auditing standards and updating a reference to a standard that is being superseded. This technical change is made because the footnote regarding misstatements in Auditing Standard No. 6 refers to SFAS No. 154, whereas the definition of "misstatement" in Auditing Standard No. 14 on evaluating audit results is neutral regarding the financial reporting framework. However, this technical change does not alter the fact that an error under accounting standards generally accepted in the United States is a misstatement under Auditing Standard No. 14.

e. Amendments to Auditing Standard No. 7

The amendments to Auditing Standard No. 7, *Engagement Quality Review,* update footnote 3 and the note to paragraph 10 to replace a reference to an interim standard that is superseded and to update the definitions of the terms "engagement partner" and "significant risk" to conform to the definitions in the risk assessment standards.

f. Amendments to Interim Auditing Standards

(i). Superseded Sections

The risk assessment standards supersede the following sections of PCAOB interim auditing standards:

- AU sec. 311, *Planning and Supervision*
- AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*
- AU sec. 313, *Substantive Tests Prior to the Balance Sheet Date*
- AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*
- AU sec. 326, *Evidential Matter*
- AU sec. 431, *Adequacy of Disclosure in Financial Statements*

Similarly, the auditing interpretations of AU secs. 311, 312, and 350 have been incorporated into the risk assessment standards and thus are superseded. The auditing interpretations of AU sec. 326, except for Interpretation No. 2 (AU secs. 9326.06–.23), also are superseded.[399]

(ii). AU sec. 316, Consideration of Fraud in a Financial Statement Audit

The relevant requirements regarding identifying and assessing fraud risks, principally AU secs. 316.14–.45; responding to fraud risks, principally AU secs. 316.46–.50; and evaluating audit results, principally AU secs. 316.68–.78, have been incorporated into Auditing Standard Nos. 12, 13, and 14, respectively. The remaining portions of AU sec. 316 describe important principles regarding the auditor's responsibility with respect to fraud and more detailed requirements regarding the auditor's responses to fraud risks. Topics covered in the remaining portions of AU sec. 316, as amended, include the following:

- A description of fraud and its characteristics,
- The importance of exercising professional skepticism,
- Examples of fraud risk factors,
- Examples of audit procedures performed to respond to fraud risks involving fraudulent financial reporting and misappropriation of assets, and
- Requirements regarding procedures to further address the risk of material misstatement due to fraud involving management override of controls, including examining journal entries and other adjustments for evidence of possible material misstatement due to fraud; reviewing accounting estimates for biases that could result in material misstatement due to fraud; and evaluating the business rationale for significant unusual transactions.

(iii). AU sec. 329, Analytical Procedures

The discussion in AU sec. 329 regarding analytical procedures performed during audit planning, principally AU secs. 329.03 and 329.06–.08, is incorporated into Auditing Standard No. 12. Similarly, the requirements regarding analytical procedures in the overall review, principally AU secs. 329.23–.24, are incorporated into Auditing Standard No. 14. The remaining portion of AU sec. 329 relates to analytical procedures performed as substantive procedures. Therefore, AU sec. 329 is retitled, *Substantive Analytical Procedures,*

[399] Interpretation No. 2 relates in part to AU sec. 336 and AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments,* and it will be evaluated in connection with standards-setting projects related to those standards.

which more accurately reflects the content of the amended standard.

A standard that focuses solely on substantive analytical procedures highlights more clearly the requirements that apply to analytical procedures performed for that purpose, including the higher degree of precision in substantive analytical procedures needed to provide the necessary level of assurance. The Board has observed instances in which auditors performed substantive procedures to test accounts without meeting the requirements in AU sec. 329 for substantive analytical procedures.[400]

(iv). AU sec. 336, Using the Work of a Specialist

The text of footnote 1 to paragraph .01 and of paragraph .05 were amended to clarify that AU sec. 336 does not apply to situations in which persons who participate in the audit have specialized skills or knowledge in accounting or auditing (*e.g.,* IT specialists and income tax specialists) and to specialists employed by the firm. Auditing Standard No. 10 applies to those situations. Those clarifications were previously included in the reproposed standard on audit planning and supervision.

(v). AU sec. 350, Audit Sampling

The discussion in AU sec. 350 regarding audit risk and tolerable misstatement has been amended to align more closely with the terminology used in the risk assessment standards.

The reproposed standards included amendments to AU secs. 350.23 and 350.38, which explained more specifically the principles in the standard for determining sample sizes when nonstatistical sampling approaches are used. Some commenters expressed concern that the reproposed amendments would have required auditors who use nonstatistical sampling methods to compute sample sizes under both statistical and nonstatistical methods to demonstrate that the sample size under the nonstatistical method equaled or exceeded the sample size determined using a statistical method.

Commenters suggested that the standard should state that it is not necessary to compute sample sizes using statistical methods. Including such a sentence in the standard might be misunderstood by auditors and weaken the requirement of the amended standard. The reproposed amendments do not require auditors to compute sample sizes using statistical methods in all instances to demonstrate compliance with the requirements. For example, the use of a nonstatistical sampling methodology that is adapted appropriately from a statistical sampling method also could demonstrate compliance. However, calculating a sample size that is not based on the relevant factors in AU sec. 350 is not in compliance with the standard. Accordingly, the amendments are retained as reproposed.

(vi). AU sec. 543, Part of Audit Performed by Other Independent Auditors, and Interpretations

A note was added to paragraph .01 to clarify that Auditing Standard No. 10 applies to situations not covered by AU sec. 543 in which the auditor engages other accounting firms or other accountants to participate in the audit. Paragraph .12 was amended to align AU sec. 543 with related amendments to Auditing Standard No. 3. Footnote 4 to paragraph .16 of AU sec. 9543, *Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543,* is deleted because it refers to an interim standard that is being superseded.

(vii). Other Amendments to the Interim Auditing Standards

For the following interim auditing standards, the amendments are limited to conforming terminology to the risk assessment standards and updating references to auditing standards that are being superseded or amended:

- AU sec. 110, *Responsibilities and Functions of the Independent Auditor*
- AU sec. 150, *Generally Accepted Auditing Standards*
- AU sec. 210, *Training and Proficiency of the Independent Auditor*
- AU sec. 230, *Due Professional Care in the Performance of Work*
- AU sec. 310, *Appointment of the Independent Auditor*
- AU sec. 315, *Communications Between Predecessor and Successor Auditors*
- AU sec. 317, *Illegal Acts by Clients*
- AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.*
- AU sec. 324, *Service Organizations*
- AU sec. 328, *Auditing Fair Value Measurements and Disclosures*
- AU sec. 330, *The Confirmation Process*
- AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*
- AU sec. 333, *Management Representations*
- AU sec. 334, *Related Parties,* and AU sec. 9334, *Related Parties: Auditing Interpretations of Section 334*
- AU sec. 9336, *Using the Work of a Specialist: Auditing Interpretations of Section 336*
- AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
- AU sec. 342, *Auditing Accounting Estimates,* and AU sec. 9342, *Auditing Accounting Estimates: Auditing Interpretations of Section 342*
- AU sec. 380, *Communication With Audit Committees*
- AU sec. 411, *The Meaning of Present 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. 722, *Interim Financial Information*

g. Amendments to Interim Ethics Standards

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

12. Effective Date

In its reproposal of the proposed rules, the Board stated that it expects the standards would be effective for audits of fiscal years beginning on or after December 15, 2010, subject to approval by the Commission, and the Board requested comment on the proposed effective date. Several commenters stated that the Board should establish sufficient time for auditing firms to make changes to their methodologies and train their staff on the new risk assessment standards.

After considering the comments received and the timing of the adoption of the standards, the Board has determined that the accompanying standards and related amendments will be effective, subject to Commission approval, for audits of fiscal periods beginning on or after December 15, 2010. In its determination, the Board considered that many auditors already employ risk-based audit methodologies, which should facilitate the methodology changes and training necessary to implement the standards by the effective date.

[400] *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).

13. Other Topics Not Related to the Reproposed Standards

The comment letters on the reproposed standards included certain comments that relate to standards-setting matters other than the reproposed standards. The following paragraphs discuss those comments.

a. Standards-setting Process

Some commenters suggested changes to the Board's standards-setting process. These comments primarily relate to the extent to which the Board uses the standards of the IAASB and ASB in its standards-setting and the use of external task forces in drafting standards.

In previous releases on its proposed risk assessment standards, the Board has stated that it has sought to eliminate unnecessary differences with the risk assessment standards and those of other standards-setters. However, because the Board's standards must be consistent with the Board's statutory mandate,[401] differences will continue to exist between the Board's standards and the standards of the IAASB and ASB *e.g.,* when the Board decides to retain an existing requirement in PCAOB standards that is not included in IAASB or ASB standards. Also, certain differences are often necessary for the Board's standards to be consistent with relevant provisions of the federal securities laws or other existing standards or rules of the Board. Also, the Board's standards-setting activities are informed by and developed to some degree, in response to observations from its oversight activities.

The Board has a number of means available to seek additional comments from external parties regarding its standards-setting activities, including meetings with its Standing Advisory Group ("SAG"), issuing concept releases or reproposing standards or rules, and conducting public roundtables. Although these are not the only means available to the Board, they have been used because they offer the Board the ability to obtain comments from a diverse group of interested parties through a public process.

The Board continually endeavors to improve its processes, including its standards-setting process, and considers comments from the public as it does so. For example, the Board has undertaken certain steps to enhance the transparency of its standards-setting process, including maintaining on its Web site its standards-setting agenda and discussing the status of projects in public meetings with the SAG. This release has also been expanded to provide additional discussion of and explanation for the Board's conclusions regarding the risk assessment standards. Some commenters acknowledged the Board's efforts to increase the transparency of its process.

b. Other Standards-Setting Projects

Commenters on the reproposed standards also recommended a number of additional standards-setting or standards-related projects for the Board. Examples of such projects included creating a codification of the Board's standards; creating a glossary of terms used in the Board's standards, issuing a concept release for the review of the Board's interim standards, developing a standard describing the overall objectives of the audit, similar to ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing,* and developing guidance related to how the Board would evaluate the reasonableness of judgments based on PCAOB auditing standards.

The Board continually assesses its standards-setting and related projects based upon the need for improvements in standards or additional guidance in response to current developments, observations from the Board's oversight activities, comments received from the public, and other factors. As mentioned previously, the Board's standards-setting agenda is maintained on the Board's Web site. The Board is considering these comments as it assesses its agenda.

c. Comparison With and the Standards of the International Auditing and Assurance Standards Board the Auditing Standards Board of the American Institute of Certified Public Accountants

Some commenters on the reproposed standards stated that the Board should provide more information about its requirements, including how the requirements are expected to affect audits. Commenters requested information about how the Board's standards compare to the standards of other standards-setters. Some commenters also requested more explanation for certain requirements in the Board's reproposed standards.

In developing its original proposed standards, the Board took into account, among other things, the risk assessment standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board of the American Institute of Certified Public Accountants ("ASB"). The release accompanying the reproposed standards included a comparison of the objectives and requirements of the reproposed standards to the analogous standards of the IAASB and ASB.

Some commenters requested additional details about differences between the reproposed standards and the IAASB or ASB standards or clarifications regarding specific requirements in the reproposed standards for which the language was not identical to IAASB or ASB standards.

In analyzing comments on the appendix to the reproposed standards that compared the reproposed standards to the analogous standards of the IAASB and ASB, the Board observed that a number of the explanations sought by commenters, *e.g.,* the reasons for the differences in certain requirements were discussed elsewhere in the release accompanying the reproposed standards, *e.g.,* in Appendix 9 to that release.

The discussion below discusses certain differences between the objectives and requirements of the PCAOB standards and the analogous standards of the IAASB and ASB. When a difference between the Board's standards and the analogous standards of the IAASB and ASB is noted, the discussion contains a reference to the discussion of the Board's requirements in this release. This analysis may not represent the views of the IAASB or ASB regarding their standards.

Auditing Standard No. 8—Audit Risk

Analogous discussions of the components of audit risk are included in the IAASB's International Standard on Auditing ("ISA") 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* and the ASB's clarified Statement on Auditing Standards ("SAS"), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards,* respectively.

(i) Audit Risk and Reasonable Assurance

PCAOB

Auditing Standard No. 8 states 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. Reasonable assurance is

[401] *E.g.,* Section 101 of the Sarbanes-Oxley Act of 2002 (the "Act"), 15 U.S.C. 7211.

obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.[402]

Auditing Standard No. 8 uses the phrase "appropriately low level" because the term "appropriately" is aligned more closely with the concept of reasonable assurance whereas "acceptable level" might be misunderstood as allowing auditors to vary the audit efforts based upon their personal tolerance for risk. This release contains additional discussion regarding the use of the phrase "appropriately low level."[403]

Auditing Standard No. 8 also clarifies that obtaining sufficient appropriate audit evidence is part of applying due professional care. This release provides additional discussion regarding due professional care and sufficient appropriate audit evidence.[404]

IAASB and ASB

The ISA states:

> To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

The SAS includes a requirement similar to the ISA's requirement.

(ii) Detection Risk and Substantive Procedures

PCAOB

Auditing Standard No. 8 states that as the appropriate level of detection risk decreases, the evidence from substantive procedures that the auditor should obtain increases. This requirement was adapted from AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit,*[405] and it parallels a requirement in Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*[406] This release contains additional discussion regarding detection risk.[407]

IAASB and ASB

The ISA and the SAS do not include an analogous requirement.

Auditing Standard No. 9—Audit Planning

In this section, the analogous IAASB and ASB standards are, unless indicated otherwise, ISA 300, *Planning an Audit of Financial Statements,* and the clarified SAS, *Planning an Audit,* respectively.

(i). Planning an Audit

PCAOB

Auditing Standard No. 9 contains a requirement to properly plan the audit. This requirement is consistent with the first standard of fieldwork in AU sec. 150, *Generally Accepted Auditing Standards.*

IAASB and ASB

The ISA and the SAS do not include an analogous requirement, although planning the audit is referenced in the objectives of the standards.

(ii). Audit Strategy and Audit Plan

PCAOB

Auditing Standard No. 9 requires the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan. When developing the audit strategy and audit plan, the standard requires the auditor to evaluate whether certain matters specified in the standard are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures. As discussed in this release, these matters are adapted from Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* and are important for both the audit of financial statements and an audit of internal control over financial reporting ("audit of internal control").[408]

In establishing the overall audit strategy, Auditing Standard No. 9 also requires the auditor to take into account certain matters, such as the reporting objectives and the factors that are significant in directing the activities of the engagement team, results of preliminary engagement activities and the auditor's evaluation of the important matters in accordance with paragraph 7, and the nature, timing, and extent of resources necessary to perform the engagement. This release discusses this requirement with more detail.[409]

Auditing Standard No. 9 requires the auditor to develop and document an audit plan that includes a description of the planned nature, timing, and extent of risk assessment procedures; tests of controls, substantive procedures, and other audit procedures. The audit plan required by Auditing Standard No. 9 encompasses all of the audit procedures to be performed, *i.e.,* it is not limited to procedures at the assertion level. This release contains additional discussion regarding developing the audit strategy and audit plan.[410]

IAASB and ASB

The ISA and the SAS require the auditor to establish an overall audit strategy that sets the scope, timing, and direction of the audit and guides the development of the audit plan. Those standards do not have a requirement analogous to the Auditing Standard No. 9 requirement to evaluate specific matters in developing the audit strategy and audit plan.

The ISA states:

> In establishing the overall audit strategy, the auditor shall:
>
> (a) Identify the characteristics of the engagement that define its scope;
>
> (b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
>
> (c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
>
> (d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
>
> (e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

The SAS includes a requirement similar to the ISA's requirement.

Both the ISA and the SAS require the auditor to develop an audit plan that shall include a description of the nature, timing, and extent of planned further auditor procedures at the assertion level.

(iii). Multi-Location Engagements

PCAOB

Auditing Standard No. 9 states that the auditor should determine the extent to which auditing procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the audit

[402] AU sec. 110, *Responsibilities and Functions of the Independent Auditor, and AU sec. 230, Due Professional Care in the Performance of Work,* provide further discussion of reasonable assurance.

[403] Section II.C.3.b.

[404] Section II.C.3.c.

[405] AU sec. 319 is superseded by the risk assessment standards.

[406] Paragraph 37 of Auditing Standard No. 13.

[407] Section II.C.3.e.

[408] Section II.C.4.e.

[409] Section II.C.4.f.

[410] Ibid.

procedures to be performed at those individual locations or business units. The auditor should assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit. Auditing Standard No. 9 also provides a list of factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures.

The provisions in Auditing Standard No. 9 are applicable to all multi-location audits. This release discusses the basis for the requirements and explains how the requirements should be applied in audits in which part of the work is performed by other auditors of financial statements of individual locations or business units that are included in the consolidated financial statements.[411]

IAASB and ASB

ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors),* and the proposed SAS, *Audits of Group Financial Statements (Including the Work of Component Auditors),* apply to group audits. Under ISA 600, group audits are defined as the audit of group financial statements, which are financial statements that include the financial information of more than one component, and the component auditor is an auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

ISA 600 and the proposed SAS describe the scope of audit procedures to be performed at individual components, depending upon, among other things, whether the components are significant components as described in the respective standards.

Auditing Standard No. 10—Supervision of the Audit Engagement

In this section, unless indicated otherwise, the analogous IAASB standards are ISA 300, *Planning an Audit of Financial Statements, and ISA 220, Quality Control for an Audit of Financial Statements* (collectively referred to in this section as “the ISAs”); and the analogous ASB standards are the clarified SAS, *Planning an Audit, and the proposed SAS, Quality Control for an Audit of Financial Statements* (collectively referred to in this section as “the SASs”).

(i). Supervision

PCAOB

Auditing Standard No. 10 states that the engagement partner is responsible for supervising other engagement team members and may seek assistance from appropriate engagement team members. Auditing Standard No. 10 also requires the engagement partner, and engagement team members who assist the engagement partner in supervision, to properly supervise the members of the engagement team, describes the necessary elements of proper supervision, and describes the factors that affect the necessary extent of supervision. These requirements are adapted from AU sec. 311, *Planning and Supervision.*[412] This release provides additional discussion regarding these requirements.[413]

The requirements in the ISAs and the SASs do not describe the elements of supervision or factors that affect supervision.

IAASB and ASB

The ISAs and the SASs require the auditor to plan the nature, timing, and extent of direction and supervision of engagement team members and review their work. The ISAs and SASs require the engagement partner to “take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements and for the auditor’s report being appropriate in the circumstances.”

(ii). Supervision of Engagement Team Members

PCAOB

Auditing Standard No. 10 requires the engagement partner and other engagement team members performing supervisory activities to: (a) Inform engagement team members of their responsibilities, including the objectives of the procedures that they are to perform; the nature, timing and extent of procedures they are to perform; and matters that could affect the procedures to be performed or the evaluation of the results of those procedures, (b) direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervising activities, and (c) review the work of engagement team members to evaluate whether the work was performed, the objectives of the procedures were achieved, and the results of the work support the conclusions. This release contains additional discussion regarding this requirement.[414]

IAASB

The ISAs state:

The engagement partner shall take responsibility for:

(a) The direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory and legal requirements; and

(b) The auditor’s report being appropriate in the circumstances.

The engagement partner shall take responsibility for reviews being performed in accordance with the firm’s review policies and procedures.

On or before the date of the auditor’s report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor’s report to be issued.

The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

ASB

The SAS includes requirements similar to the ISAs’ requirements.

(iii). Extent of Supervision

PCAOB

To determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, Auditing Standard No. 10 requires the engagement partner and other engagement team members performing supervisory activities to take into account the nature of company, the nature of the assigned work for each team member, the risks of material misstatement, and the knowledge, skill, and ability of each engagement team member. This release contains additional discussion regarding this requirement.[415]

IAASB and ASB

The ISAs and SASs do not have an analogous requirement for the auditor to determine the extent of supervision necessary for engagement team members.

[411] Section II.C.4.g.

[412] AU sec. 311 is superseded by Auditing Standard No. 9 and Auditing Standard No. 10.

[413] Section II.C.5.d.

[414] Section II.C.5.e.

[415] Ibid.

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

In this section, the analogous IAASB and ASB standards are ISA 320, *Materiality in Planning and Performing an Audit,* and the clarified SAS, *Materiality in Planning and Performing an Audit,* and the proposed SAS, *Audits of Group Financial Statements (Including the Work of Component Auditors),* respectively.

• Definition of Materiality

PCAOB

Auditing Standard No. 11 requires the auditor to establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances, including consideration of the company's earnings and other relevant factors. The requirement in Auditing Standard No. 11 is based on the concept of materiality that is articulated by the courts in interpreting the federal securities laws. This release discusses the concept of materiality used in Auditing Standard No. 11.[416]

IAASB and ASB

The ISA states, "When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole."

The SAS has a requirement similar to the ISA's requirement.

• Materiality in the Context of an Audit

PCAOB

Auditing Standard No. 11 requires the auditor to plan and perform audit procedures to detect misstatements that, individually or in combination with other misstatements, would result in material misstatement of the financial statements in order to obtain reasonable assurance about whether the financial statements are free of material misstatement. This release discusses the concept of materiality in the context of an audit.[417]

IAASB

ISA 200 states:

In conducting an audit of financial statements, the overall objectives of the auditor are:

a. To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

b. To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.

ASB

The SAS includes an objective similar to the ISA's objective.

• Tolerable Misstatement and Performance Materiality

PCAOB

Auditing Standard No. 11 requires the auditor to determine tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level. Auditing Standard No. 11 uses the term "tolerable misstatement," which is also used in other PCAOB standards.[418] This release discusses the use of the term "tolerable misstatement" in more detail.[419]

IAASB and ASB

The ISA and SAS require the auditor to determine "performance materiality" for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures.

• Determining Tolerable Misstatement

PCAOB

Auditing Standard No. 11 contains a requirement to take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods when determining tolerable misstatement and planning and performing audit procedures. This requirement is adapted from AU sec. 312, *Audit Risk and Materiality in Conducting an Audit.* This release contains further discussion regarding this requirement.[420]

IAASB and ASB

The ISA and SAS do not have an analogous requirement.

• Multi-Location Determination of Tolerable Misstatement

PCAOB

In multi-location engagements, Auditing Standard No. 11 requires the auditor to determine tolerable misstatement for the individual locations or business units at an amount that reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the consolidated financial statements. The standard also requires the tolerable misstatement at an individual location to be less than the established materiality level for the financial statements as a whole. This release provides further discussion regarding consideration of materiality for multi-location engagements.[421]

IAASB

ISA 600 requires the group engagement team to determine, among other things, component materiality. The ISA states:

> Component materiality for those components where component auditors will perform an audit or a review for purposes of the group audit. To reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole, component materiality shall be lower than materiality for the group financial statements as a whole.

ASB

Proposed SAS, *Audits of Group Financial Statements (Including the Work of Component Auditors),* requires the group engagement team to determine among other things, component materiality. The proposed SAS states:

> Component materiality for those components on which an audit or other specified audit procedures will be performed. To reduce the risk that the aggregate of detected and undetected misstatements in the group financial statements exceeds the materiality for the group financial statements as a whole, component materiality should be lower than the materiality for the group financial statements as a whole.

• Reevaluating Materiality and Tolerable Misstatement

PCAOB

Auditing Standard No. 11 requires the auditor to reevaluate the established materiality level or levels and tolerable misstatement when there is a substantial likelihood that misstatements of amounts that differ significantly from the materiality level or levels that were established initially would influence the judgment of a reasonable investor. The requirement reflects the perspective of a reasonable investor, whereas the analogous requirements in the ISA and SAS reflect an auditor's perspective. This release contains additional discussion regarding materiality from

[416] Section II.C.6.b.

[417] Ibid.

[418] Paragraph .18 of AU sec. 350, *Audit Sampling.*

[419] Section II.C.6.e.

[420] *Ibid.*

[421] Section II.C.6.f.

the perspective of a reasonable investor[422] and the reevaluation of materiality.[423]

IAASB and ASB

The ISA and the SAS require the auditor to "revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances, or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially."

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

In this section, the analogous IAASB standards are ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment,* and ISA 240, *The Auditor's Responsibilities Relating to Fraud In An Audit of Financial Statements* (collectively referred to in this section as "the ISAs"). The analogous ASB standards are the clarified SAS, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatements* (Redrafted) and proposed SAS, *Consideration of Fraud in a Financial Statement Audit* (Redrafted) (collectively referred to in this section as "the SASs").[424]

(i). Objective

PCAOB

The objective of Auditing Standard No. 12 is to identify and appropriately assess the risks of material misstatement, thereby providing a basis for designing and implementing responses to the risks of material misstatement. Auditing Standard No. 12 requires the auditor to perform other risk assessment procedures in addition to obtaining an understanding of the company and its environment. This release contains additional discussion regarding the objective of the standard.[425]

IAASB and ASB

The ISAs state:

> The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

The SASs include an objective similar to the ISAs' objective.

(ii). Performing Risk Assessment Procedures

PCAOB

Auditing Standard No. 12 states that the auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to error or fraud, and designing further audit procedures. The requirement establishes a principle for determining the sufficiency of the necessary risk assessment procedures, and it also links the risk assessment procedures to the design of the tests of controls and substantive procedures to be performed to respond to the risks. This release includes additional discussion regarding performing risk assessment procedures.[426]

IAASB and ASB

The ISAs state:

> The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

The SASs include a requirement similar to the ISAs' requirement.

(iii). Obtaining an Understanding of the Company and Its Environment

PCAOB

Auditing Standard No. 12 includes a requirement to evaluate, while obtaining an understanding of the company, whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement. This release includes additional discussion regarding obtaining an understanding of the company and its environment.[427]

IAASB and ASB

The ISAs and SASs do not include an analogous requirement.

(iv). Additional Procedures To Understand the Company

PCAOB

Auditing Standard No. 12 requires the auditor to consider performing certain procedures as part of obtaining an understanding of the company as required by paragraph 7 of the standard. These procedures include reading public information about the company, observing or reading transcripts of earnings calls, obtaining an understanding of compensation arrangements with senior management, and obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders. This release includes additional discussion regarding this requirement.[428]

IAASB and ASB

The ISAs and SASs do not include an analogous requirement.

(v). Selection and Application of Accounting Principles, Including Related Disclosures

PCAOB

Auditing Standard No. 12 requires the auditor to develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework to identify and assess the risks of material misstatement related to omitted, incomplete, or inaccurate disclosures.[429] The standard also requires engagement team members to discuss how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures.[430] Additionally Auditing Standard No. 12 requires the auditor's evaluation of fraud risk factors to include how fraud could be perpetrated or concealed by presenting incomplete or inaccurate disclosures or by omitting disclosures that are necessary for the financial statements to be presented fairly in conformity with the applicable financial reporting framework.[431] This release includes additional discussion regarding these requirements.[432]

IAASB and ASB

The ISAs and SASs do include analogous requirements regarding the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework.

[422] Section II.C.6.b.

[423] Section II.C.6.g.

[424] In June 2010, the ASB adopted as a final standard the SAS, *Consideration of Fraud in a Financial Statement Audit (Redrafted).* However, the ASB has not yet published this standard.

[425] Section II.C.7.b.

[426] Section II.C.7.c.

[427] Section II.C.7.d.

[428] *Ibid.*

[429] Paragraph 12 of Auditing Standard No. 12.

[430] Paragraph 52 of Auditing Standard No. 12.

[431] Paragraph 67 of Auditing Standard No. 12.

[432] Section II.C.7.d., h. and j. respectively.

(vi). Obtaining an Understanding of Internal Control Over Financial Reporting

PCAOB

Auditing Standard No. 12 requires the auditor to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements; (b) assess the factors that affect the risks of material misstatement; and (c) design further auditor procedures. This requirement relates to the sufficiency of the required understanding of internal control over financial reporting. This release contains additional discussion of this requirement.[433]

IAASB and ASB

The ISAs state:

> The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

The SASs include requirements similar to the ISAs' requirements.

(vii). Control Environment

PCAOB

Auditing Standard No. 12 requires the auditor 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 requirement is aligned with a similar requirement in Auditing Standard No. 5. This release includes additional discussion regarding this requirement.[434]

Paragraph 25 of Auditing Standard No. 12 states that "[i]f 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." This release includes additional discussion regarding the auditor's evaluation of an identified control deficiency in the control environment.[435]

IAASB and ASB

The ISAs state:

> The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
> (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
> (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment.

The SASs include requirements similar to the ISAs' requirements.

The ISAs and SASs do not have a requirement analogous to paragraph 25 of Auditing Standard No. 12.

(viii). The Company's Risk Assessment Process

PCAOB

Auditing Standard No. 12 states that:

> The auditor should obtain an understanding of management's process for:
> (a) Identifying risks relevant to financial reporting objectives, including risks of material misstatement due to fraud ("fraud risks"),
> (b) Assessing the likelihood and significance of misstatements resulting from those risks, and
> (c) Deciding about actions to address those risks.

The standard also states that obtaining an understanding of the company's risk assessment process includes obtaining an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.

Those requirements focus on the matters that are important to the auditor's understanding of the company's internal control and on the auditor's risk assessments. Although the auditor can be informed by the company's risk assessment process, the auditor is still required to perform risk assessment procedures that are sufficient for identifying and assessing the risks of material misstatement rather than relying on the company's process.

This release includes additional discussion regarding the company's risk assessment process.[436]

IAASB and ASB

The ISAs state:

> The auditor shall obtain an understanding of whether the entity has a process for (a) Identifying business risks relevant to financial reporting objectives; (b) Estimating the significance of the risks; (c) Assessing the likelihood of their occurrence; and (d) Deciding about actions to address those risks.
> If the entity has established such a process (referred to hereafter as the "entity's risk assessment process"), the auditor shall obtain an understanding of it, and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process.
> If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control.

The SASs include requirements similar to the ISAs' requirements.

(ix). Information and Communication

PCAOB

Auditing Standard No. 12 requires the auditor to obtain an understanding of how IT affects the company's flow of transactions. The standard also states that the identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the approach used to identify significant accounts and disclosures and their relevant assertions and, when applicable, to select the controls to test, as well as to assess risk and allocate audit effort. This release contains additional discussion of this requirement.[437]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(x). Control Activities

PCAOB

Auditing Standard No. 12 requires the auditor to 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. Auditing Standard No. 12 requires the auditor to use his or her knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control over financial reporting in determining

[433] Section II.C.7.e.

[434] Section II.C.7.e.(ii).

[435] Ibid.

[436] Section II.C.7.e.(iii).

[437] Section II.C.7.e.(iv).

the extent to which it is necessary to devote additional attention to obtaining an understanding of control activities to assess the factors that affect the risks of material misstatement and to design further audit procedures. This release includes additional discussion of this requirement.[438]

IAASB

The ISAs state:

The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them.

ASB

The SASs state:

The auditor should obtain an understanding of control activities relevant to the audit, which are those control activities the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. However, the auditor should obtain an understanding of the process of reconciling detailed records to the general ledger for material account balances.

(xi). Relationship of Understanding of Internal Control to Tests of Controls

PCAOB

Auditing Standard No. 12 requires the auditor to take into account the evidence obtained from understanding internal control when assessing control risk and, in the audit of internal control, forming conclusions about the effectiveness of controls. Auditing Standard No. 12 also requires the auditor to take into account the evidence obtained from understanding internal control when determining the nature, timing, and extent of procedures necessary to support the auditor's conclusions about the effectiveness of entity-level controls in the audit of internal control. This release includes additional discussion of these requirements.[439]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(xii). Considering Information From the Client Acceptance and Retention Evaluation, Audit Planning Activities, Past Audits, and Other Engagements

PCAOB

Auditing Standard No. 12 requires the auditor to evaluate whether information obtained during a review of interim financial information in accordance with AU sec. 722, *Interim Financial Information,* is relevant to identifying risks of material misstatement in the year-end audit. The ISAs and SASs do not include an analogous requirement.

Auditing Standard No. 12 also states that the auditor should obtain an understanding of the nature of the services that have been performed for the company by the auditor or affiliates of the firm[440] and should take into account relevant information obtained from those engagements in identifying risks of material misstatement. The requirement in Auditing Standard No. 12 applies to services performed by the firm and affiliates of the firm and is not limited to services performed by the engagement partner. This release contains additional discussion regarding these requirements.[441]

IAASB and ASB

The ISAs state, "[i]f the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement."

The SASs include a requirement similar to the ISAs' requirement.

(xiii). Performing Analytical Procedures

PCAOB

Auditing Standard No. 12 contains a series of requirements regarding performing analytical procedures as risk assessment procedures. These requirements were adapted from AU sec. 329, *Analytical Procedures.* Auditing Standard No. 12 requires the auditor to:

- Perform analytical procedures that are designed to (a) enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior year end; and (b) identify areas that might represent specific risks relevant to the audit, including the existence of unusual transactions and events, and amounts, ratios, and trends that warrant investigation.
- Perform analytical procedures regarding revenue as risk assessment procedures with the objective of identifying unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud.
- Take into account analytical procedures performed in accordance with AU sec. 722 when designing and applying analytical procedures as risk assessment procedures. This requirement is unique to PCAOB standards.
- Use his or her understanding of the company to develop expectations about plausible relationships among the data to be used in the procedure.[442]
- Take into account unusual or unexpected differences from the auditor's expectations that are identified while performing analytical procedures as risk assessment procedures.

This release contains additional discussion of these requirements.[443]

IAASB

The ISAs state:

The risk assessment procedures shall include * * * [a]nalytical procedures * * *

The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

ASB

The SASs state:

The risk assessment procedures should include * * * [a]nalytical procedures * * *

Based on analytical procedures performed as part of risk assessment procedures and as part of substantive procedures, the auditor should evaluate whether unusual or unexpected relationships that have been identified indicate risks of material misstatements due to fraud. To the extent not already included, the analytical procedures and evaluation thereof should include procedures relating to revenue accounts.

(xiv). Communication Among Engagement Team Members

PCAOB

Auditing Standard No. 12 requires that the communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when

[438] Section II.C.7.e.(v).

[439] Section II.C.7.e.(vii).

[440] *See* PCAOB Rule 3501(a)(i), which defines "affiliate of the accounting firm."

[441] Section II.C.7.f.(ii).

[442] Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.

[443] Section II.C.7.g.

conditions change. This release contains additional discussion of this requirement.[444]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(xv). Discussion of the Potential for Material Misstatement Due to Fraud

PCAOB

Auditing Standard No. 12 requires a discussion among the key engagement team members of specified matters regarding fraud, including how and where the company's financial statements might be susceptible to material misstatement due to fraud, known fraud risk factors, the risk of management override of controls, and possible responses to fraud risks.

Auditing Standard No. 12 requires all key engagement team members to participate in the discussion. Auditing Standard No. 12 also states that key engagement team members include the engagement partner and other engagement team members with significant engagement responsibilities.

Auditing Standard No. 12 also includes a requirement to emphasize certain matters to all engagement team members, including the need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, to be alert for information or other conditions that might affect the assessment of fraud risks, and actions to be taken if information or other conditions indicate that a material misstatement due to fraud might have occurred.

This release includes additional discussion of these requirements.[445]

IAASB

The ISAs state:

> The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion.
>
> * * * This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur.

ASB

The SASs have requirements similar to the ISAs' requirements. However, the SASs also include a requirement that the discussion regarding fraud include an exchange among engagement team members about how and where the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. The SASs also include a requirement to emphasize certain matters to all engagement team members, but those matters identified are less extensive than those required by PCAOB standards.

(xvi). Inquiring of the Audit Committee, Management, and Others Within the Company About the Risks of Material Misstatement

PCAOB

Auditing Standard No. 12 requires the auditor to make specified inquiries of management and the audit committee regarding tips or complaints about the company's financial reporting. This release includes additional discussion of this requirement.[446]

IAASB and ASB

The ISAs and the SASs do not specify the nature of the required inquiries, except for certain inquiries regarding fraud, which are less extensive than those required by PCAOB standards.

(xvii). Nature of Inquiries

PCAOB

Auditing Standard No. 12 requires the auditor to 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 inquiries about risks of material misstatement. This release includes additional discussion of this requirement.[447]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(xviii). Evaluating Management Responses to Inquiries

PCAOB

Auditing Standard No. 12 requires the auditor to take into account the fact that management is often in the best position to commit fraud when evaluating management's responses to inquiries about fraud risks. Auditing Standard No. 12 also requires the auditor to obtain evidence to address inconsistencies in response to the inquiries. This release includes additional discussion of these requirements.[448]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(xix). Identifying and Assessing the Risks of Material Misstatement

PCAOB

Auditing Standard No. 12 requires the auditor to evaluate how risks at the financial statement level could affect risks of material misstatement at the assertion level. This release includes additional discussion of this requirement.[449]

IAASB and ASB

The ISAs and the proposed SAS do not include an analogous requirement.

(xx). Identifying Significant Accounts and Disclosures and Their Relevant Assertions

PCAOB

Auditing Standard No. 12 requires the auditor to identify significant accounts and disclosures and their relevant assertions in identifying and assessing risks of material misstatement. PCAOB standards require auditors to perform substantive procedures for relevant assertions of significant accounts and disclosures in the audit of financial statements and tests of controls over relevant assertions of significant accounts and disclosures in the audit of internal control. This release includes additional discussion regarding identifying significant accounts and disclosures and relevant assertions.[450]

IAASB and ASB

The ISAs and SASs do not have an analogous requirement.

(xxi). Significant Risks

PCAOB

Auditing Standard No. 12 defines significant risk as a "risk of material misstatement that requires special audit consideration." This definition is different from the ISAs' definition because it omits two qualifying phrases, "an identified and assessed" and "in the auditor's judgment." This release includes additional discussion regarding the definition of significant risks.[451]

444 Section II.C.7.h.(ii).

445 Section II.C.7.h.

446 Section II.C.7.i.

447 Ibid.

448 Ibid.

449 Section II.C.7.j.

450 Ibid.

451 Section II.C.7.k.

IAASB and ASB

The ISAs and SASs define significant risk as "an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration."

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

In this section, the analogous IAASB standards are ISA 330, *The Auditor's Responses to Assessed Risks,* and ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* (collectively referred to in this section as "the ISAs"). The analogous ASB standards are the clarified SAS, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (Redrafted), and the proposed SAS, *Consideration of Fraud in a Financial Statement Audit* (Redrafted) (collectively referred to in this section as "the SASs").

(i). Objective

PCAOB

The objective of the auditor in Auditing Standard No. 13 is "to address the risks of material misstatement through appropriate overall audit responses and audit procedures." The objective in the proposed standard emphasizes the auditor's responsibility for responding to the risks of material misstatements. This release contains additional discussion regarding the objective of the standard.[452]

IAASB and ASB

The objective in the ISAs and the SASs is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

(ii). Overall Responses to Risks

PCAOB

Auditing Standard No. 13 requires the auditor to design and implement certain overall responses (*e.g.,* making appropriate assignments of specific engagement responsibilities, providing an appropriate extent of supervision, incorporating elements of unpredictability in selecting auditing procedures, and evaluating the company's selection and application of significant accounting principles) to address risks of material misstatement. These responses are not limited to addressing risks at the financial statement level. They are also intended to address risks at the significant account or disclosure level due to the nature of these specific overall responses. This release contains additional discussion of this requirement.[453]

IAASB and ASB

The ISAs and the SASs include requirements to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level and requirements for particular types of responses to the risks of material misstatement due to fraud at the financial statement level.

(iii). Determination of the Need for Pervasive Changes

PCAOB

Auditing Standard No. 13 requires the auditor to determine whether it is necessary to make pervasive changes to the nature, timing, or extent of audit procedures to adequately address the assessed risk of material misstatement. Examples of such pervasive changes include modifying the audit strategy to increase the substantive testing of the valuation of numerous significant accounts at year end because of significantly deteriorating market conditions and to obtain more pervasive audit evidence from substantive procedures due to the identification of pervasive weaknesses in the company's control environment. This release includes detailed discussions regarding making pervasive changes as an overall response to risks of material misstatement.[454]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(iv). Application of Professional Skepticism

PCAOB

Auditing Standard No. 13 states that due professional care requires the auditor to exercise professional skepticism, requires that the auditor apply professional skepticism in gathering and evaluating audit evidence in response to risks of material misstatement, and provides examples of the appropriate application of professional skepticism. This release includes additional discussion regarding application of professional skepticism.[455]

IAASB and ASB

The ISAs state

* * * the auditor shall maintain an attitude of professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.

The SASs include a requirement similar to the ISAs' requirement.

(v). Evidence About the Effectiveness of Controls

PCAOB

In discussing testing controls in an audit of financial statements, Auditing Standard No. 13 establishes the principle that the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The greater the reliance on a control, the more persuasive evidence the auditor is required to obtain from the tests of controls.

In addition, the standard requires the auditor to obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls. This release includes additional discussions of these requirements.[456]

IAASB and ASB

The ISAs and the SASs include a requirement for the auditor to obtain more persuasive audit evidence the greater the reliance he or she plans to place on the effectiveness of a control, but they do not have an analogous requirement regarding situations in which the audit approach consists primarily of tests of controls.

(vi). Testing the Operating Effectiveness of a Control

PCAOB

Auditing Standard No. 13 requires the auditor to determine whether the control selected for testing is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. The standard also discusses the procedures the auditor performs in testing operating effectiveness. To help facilitate the tests of controls in an integrated audit, the standard continues to use language similar to that of Auditing Standard No. 5 when describing analogous terms and concepts relating to the testing of

[452] Section II.C.8.b.

[453] Section II.C.8.c.

[454] *Ibid.*

[455] *Ibid.*

[456] Section II.C.8.f.(iii).

controls. This release includes additional discussion regarding this requirement.[457]

IAASB

The ISAs do not include an analogous requirement to determine whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

ASB

The SASs state:

In designing and performing tests of controls, the auditor should: *a.* perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including * * * by whom or by what means they were applied, including, when applicable, whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

(vii). Tests of Controls in an Integrated Audit

PCAOB

Auditing Standard No. 13 requires the auditor to perform tests of controls in integrated audits to meet the objectives of both the audit of financial statements and the audit of internal control. This release includes additional discussion of this requirement.[458]

IAASB and ASB

The ISAs and the SASs do not include an analogous requirement.

(viii). Rotational Testing of Controls

PCAOB

Auditing Standard No. 13 requires the auditor to obtain evidence during the current year audit about the design and operating effectiveness of controls upon which the auditor relies. This release includes additional discussion of this requirement.[459]

IAASB and ASB

The ISAs and the SASs include requirements that apply to the use of evidence about controls obtained in prior audits and allow rotational testing of controls under certain conditions set forth in those standards.

(ix). Assessing Control Risk

PCAOB

Auditing Standard No. 13 requires the auditor to assess control risk for relevant assertions by evaluating the evidence from all sources, including the auditor's testing of controls for the audit of internal control and the audit of financial statements, misstatements detected during the financial statement audit, and any identified control deficiencies. The standard also requires that control risk be assessed at the maximum level for relevant assertions (1) for which controls necessary to sufficiently address the assessed risk of material misstatement in those assertions are missing or ineffective or (2) when the auditor has not obtained sufficient appropriate audit evidence to support a control risk assessment below the maximum level. This release includes additional discussion of these requirements.[460]

IAASB and ASB

The ISAs and the SASs include requirements regarding evaluating the operating effectiveness of controls and identified control deviations, but those standards do not require a specific assessment of control risk.

(x). Substantive Procedures

PCAOB

Auditing Standard No. 13 requires the auditor to perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk. This requirement reflects the principle that the auditor needs to implement appropriate responses to address assessed risks of material misstatement. This release contains additional discussion of this requirement.[461]

IAASB

The ISAs state, "Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure."

ASB

The SASs state, "Irrespective of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure."

The requirements in the ISAs and the SASs focus on the accounts and disclosures that are material, regardless of whether they are associated with identified risks of material misstatement.

(xi). Consideration of Confirmations

PCAOB

Auditing Standard No. 13 requires the auditor to perform substantive procedures for each relevant assertion of each significant account and disclosure. The standard also discusses how to determine the types and combination of substantive audit procedures necessary to detect material misstatements in relevant assertions.

AU sec. 330, *The Confirmation Process,* establishes requirements regarding the use of confirmation procedures.[462] The risk assessment standards discuss the auditor's responsibilities for designing and performing the substantive procedures necessary to address the risks of material misstatement.

IAASB and ASB

ISA 330 specifically requires the auditor to consider whether external confirmation procedures are to be performed as substantive audit procedures. The ASB has proposed to amend the SASs to require the auditor to consider whether external confirmation procedures are to be performed as substantive audit procedures and to require the use of external confirmation procedures for material accounts receivable.

(xii). Determining Whether To Perform Interim Substantive Procedures

PCAOB

Auditing Standard No. 13 requires the auditor to take into account a series of factors when determining whether it is appropriate to perform substantive procedures at an interim date. This release includes provides additional discussion regarding timing of substantive procedures.[463]

IAASB and ASB

The ISAs and the SASs do not include an analogous requirement for the auditor to take into account the factors listed in Auditing Standard No. 13 when determining whether it is appropriate to perform substantive procedures at an interim date.

(xiii). Substantive Procedures Covering the Remaining Period

PCAOB

Auditing Standard No. 13 states, "When substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive

[457] Section II.C.8.f.(iv).

[458] Section II.C.8.d.

[459] Section II.C.8.f.(vi).

[460] Section II.C.8.f.(vii).

[461] Section II.C.8.g.

[462] The Board has a separate standards-setting project on confirmations.

[463] Section II.C.8.h.

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." The standard contains a specific requirement to compare relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual. This release includes additional discussion of this requirement.[464]

IAASB and ASB

The ISAs and the SASs include requirements to cover the period between the interim testing date and year end by performing substantive procedures, combined with tests of controls for the intervening period, or by performing further substantive procedures only if the auditor determines that doing so would be sufficient. The ISAs and SASs do not include an analogous requirement regarding the specific procedures to be performed.

(xiv). Response to Significant Risks

PCAOB

Auditing Standard No. 13 requires the auditor to perform substantive procedures, including tests of details, that are specifically responsive to significant risks. This release contains additional discussion of this requirement.[465]

IAASB and ASB

The ISAs state:

> If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

The SASs include requirements similar the ISAs' requirements.

(xv). Dual-purpose Tests

PCAOB

Auditing Standard No. 13 states that, when dual-purpose tests are performed, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested. This release contains additional discussion of this requirement.[466]

IAASB and ASB

The ISAs and the SASs do not include analogous requirements.

Auditing Standard No. 14—Evaluating Audit Results

In this section, the analogous IAASB standards are ISA 450, Evaluation of Misstatements Identified During the 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, ISA 540, Auditing Accounting Estimates Including Fair Value Accounting Estimates, and Related Disclosures, and ISA 700, Forming an Opinion and Reporting on Financial Statements (collectively referred to in this section as "the ISAs"). The analogous ASB standards are clarified SAS Evaluation of Misstatements Identified During the Audit, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (Redrafted), Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement (Redrafted), and proposed SAS Consideration of Fraud in a Financial Statement Audit (Redrafted), Analytical Procedures (Redrafted), and Forming an Opinion and Reporting on Financial Statements (collectively referred to in this section as "the SASs").

(i). Performing Analytical Procedures in the Overall Review

PCAOB

In the overall review, Auditing Standard No. 14 contains specific requirements for the auditor to read the financial statements and disclosures and perform analytical procedures to (a) evaluate the auditor's conclusions formed regarding significant accounts and disclosures and (b) assist in forming an opinion on whether the financial statements as a whole are free of material misstatement. These requirements were adapted from existing requirements in PCAOB standards.[467] The conclusions formed from the results of the overall review of the audit are intended to inform the auditor's conclusions regarding significant accounts and disclosures and the opinion on the financial statements. This release includes additional discussion of these requirements.[468]

IAASB

The ISAs state:

> The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

ASB

The SASs state:

> The auditor should design and perform analytical procedures near the end of the audit that are intended to corroborate audit evidence obtained during the audit of financial statements to assist the auditor in drawing reasonable conclusions on which to base the auditor's opinion.

(ii). Evaluating Evidence From Analytical Procedures

PCAOB

Auditing Standard No. 14 contains a requirement, which was adapted from an existing requirement in PCAOB standards,[469] for the auditor, as part of the overall review to evaluate whether (a) the evidence gathered in response to unusual or unexpected transactions, events, amounts or relationships previously identified during the audit is sufficient and (b) unusual or unexpected transactions, events, amounts, or relationships indicate risks of material misstatement that were not identified previously, including, in particular, fraud risks. Auditing Standard No. 14 also specifically requires the auditor to evaluate whether the evidence gathered during the audit is sufficient as part of the overall review.

Also, the requirements in Auditing Standard No. 14 relate to risks of material misstatement due to error or fraud, whereas the requirements in the ISAs and SASs are limited to fraud risks. This release includes additional discussion of these requirements in Auditing Standard No. 14.[470]

IAASB

The ISAs state:

> The auditor shall evaluate whether analytical procedures that are performed near the end of the audit, when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment, indicate a previously unrecognized risk of material misstatement due to fraud.

ASB

The SASs state:

> The auditor should evaluate whether the accumulated results of auditing procedures,

[464] *Ibid.*

[465] Section II.C.8.i.

[466] Section II.C.8.j.

[467] AU sec. 329.23.

[468] Section II.C.9.c.

[469] AU sec. 329.23.

[470] Section II.C.9.c.

including analytical procedures, that are performed during the audit, in the overall review stage, or in both stages, when forming an overall conclusion concerning whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment, indicate a previously unrecognized risk of material misstatement due to fraud.

(iii). Analytical Procedures Regarding Revenue

PCAOB

Auditing Standard No. 14 includes a requirement, adapted from an existing requirement in AU sec. 316, for the auditor to perform analytical procedures relating to revenue through the end of the period. These procedures are intended to identify unusual or unexpected relationships involving revenue accounts that might indicate a material misstatement, including material misstatement due to fraud. This release includes additional discussion of this requirement.[471]

IAASB

The ISAs state:

The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

The ISAs do not specifically require the auditor to perform analytical procedures related to revenue through the end of the period.

ASB

The SASs require the auditor to perform analytical procedures related to revenue.

(iv). Corroborating Management Explanations

PCAOB

Auditing Standard No. 14 requires the auditor to corroborate management's explanations regarding significant unusual or unexpected transactions, events, amounts, or relationships. Auditing Standard No. 14 also states that if management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise, or not at a sufficient level of detail to be useful, the auditor should perform procedures to address the matter. Unlike the ISAs, Auditing Standard No. 14 specifically requires the auditor to corroborate management's explanations regarding significant matters. This release includes additional discussion regarding corroborating management's explanations.[472]

IAASB and ASB

The ISAs and the SASs require the auditor to investigate the identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount by (a) inquiring of management and obtaining appropriate audit evidence relevant to management's responses and (b) performing other audit procedures as necessary in the circumstances. The ISAs and the SASs also include a requirement to investigate inconsistent responses to inquiries from management and those charged with governance.

(v). Communication of Accumulated Misstatements

PCAOB

Auditing Standard No. 14 requires the auditor to communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them. Unlike the ISAs and the SASs, Auditing Standard No. 14 does not require the auditor to request management to correct the misstatements. Instead, PCAOB standards focus on communicating the misstatements to management, performing procedures to determine whether management corrected them, understanding the reasons why management might not have corrected the misstatements, and evaluating the effect of uncorrected misstatements on the financial statements and the audit. This release includes additional discussion of this requirement.[473]

IAASB and ASB

The ISAs and the SASs include requirements to communicate on a timely basis all misstatements accumulated during the audit to an appropriate level of management and to request that management correct those misstatements.

(vi). Correction of Misstatements

PCAOB

Auditing Standard No. 14 requires that if management has made corrections to accounts or disclosures in response to misstatements detected by the auditor, the auditor should evaluate management's work to determine whether the corrections have been appropriately recorded and determine whether uncorrected misstatements remain. This release includes additional discussion of this requirement.[474]

IAASB and ASB

The ISAs and the SASs contain a requirement to perform additional audit procedures to determine whether misstatements remain, if at the auditor's request management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected.

The ISAs do not require the auditor to evaluate whether the misstatements that were communicated by the auditor to management have been appropriately corrected by management.

(vii). Evaluating Misstatements—Effect on Risk Assessments

PCAOB

Auditing Standard No. 14 contains a requirement to evaluate the nature and the effects of individual misstatements accumulated during the audit on the assessed risks of material misstatement in determining whether the risk assessments remain appropriate. This release includes additional discussion of this requirement.[475]

IAASB and ASB

The ISAs and the SASs do not include an analogous requirement.

(viii). Evaluating Whether Misstatements Might Be Indicative of Fraud

PCAOB

Auditing Standard No. 14 requires the auditor to perform procedures 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 if the auditor believes that a misstatement is or might be intentional, and if the effect on the financial statement cannot be readily determined. This release includes additional discussions of this requirement.[476]

IAASB and ASB

The ISAs require the auditor to evaluate the implications for the audit if the auditor confirms that or is unable to conclude whether financial statements are materially misstated as a result of fraud. The ISA does not explicitly require the auditor to perform audit procedures to obtain additional audit evidence to determine the effect of the misstatement on the financial statements.

[471] Ibid.

[472] *Ibid.*

[473] Section II.C.9.j.

[474] Section II.C.9.f.

[475] Section II.C.9.i.

[476] Ibid.

The SASs include a requirement similar to the ISAs' requirement.

(ix). Communications Regarding Fraud

PCAOB

Auditing Standard No. 14 requires the auditor to determine his or her responsibility under AU secs. 316.79–.82A, AU sec. 317, *Illegal Acts by Clients,* and Section 10A of the Securities and Exchange Act of 1934, 15 U.S.C. 78j–1, if the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred. AU sec. 316 requires that whenever the auditor has determined that there is evidence that fraud may exist, the auditor should bring that matter to the attention of an appropriate level of management.[477] This release includes additional discussion of this requirement.[478]

IAASB and ASB

The ISAs state that if the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management.

The SASs include a requirement similar to the ISAs' requirement.

(x). Evaluating the Qualitative Aspects of the Company's Accounting Practices

PCAOB

Auditing Standard No. 14 states that if the auditor identifies bias in management's judgments about the amounts and disclosures in the financial statements, the auditor should evaluate whether the effect of that bias, together with the effect of uncorrected misstatements, results in material misstatement of the financial statements. The standard also contains a requirement for the auditor to evaluate whether the auditor's risk assessments, including the assessment of fraud risks, and the related responses remain appropriate. This release includes additional discussion of these requirements.[479]

IAASB and ASB

The ISAs and the SASs contain a requirement for the auditor to evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

(xi). Management's Identification of Offsetting Adjusting Entries

PCAOB

If management identifies adjusting entries that offset misstatements accumulated by the auditor, Auditing Standard No. 14 requires the auditor to perform procedures to determine why the misstatements were not identified previously and to evaluate the implications on the integrity of management and the auditor's risk assessments, including fraud risk assessments. Auditing Standard No. 14 also requires the auditor to perform additional procedures as necessary to address the risk of further undetected misstatements. This release includes additional discussion of these requirements.[480]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

(xii). Evaluating Conditions Relating to Assessment of Fraud Risks

PCAOB

Auditing Standard No. 14 requires the engagement partner to determine whether there has been appropriate communication with other engagement team members throughout the audit regarding information or conditions that are indicative of fraud risks. This release includes additional discussion of this requirement.[481]

IAASB

The ISAs require a discussion among the engagement team members and a determination by the engagement partner of matters to be communicated to those team members not involved in the discussion.

ASB

The SASs contain a requirement for the engagement partner to ascertain that appropriate communication exists about the need for the discussion of fraud risks among team members throughout the audit.

Auditing Standard No. 15—Audit Evidence

In this section, the analogous IAASB and ASB standards are ISA 500, *Audit Evidence,* and the clarified SAS, *Audit Evidence (Redrafted),* respectively.

(i). Objective and Overarching Requirement

PCAOB

The objective of the auditor in Auditing Standard No. 15 is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report. The objective of the standard, together with the related requirement regarding audit evidence, articulates the linkage between the auditor's responsibility to obtain sufficient appropriate audit evidence and to support his or her opinion. This release includes additional discussion regarding the objective of the standard.[482]

IAASB and ASB

The ISA states:

> The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

The ISA also states:

> The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

The SAS includes an objective and a requirement similar to the ISA's objective and requirement.

(ii). Document Authentication

PCAOB

Auditing Standard No. 15 states that 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 is required to modify the planned audit procedures or perform additional audit procedures to respond to those conditions and to evaluate the effect, if any, on the other aspects of the audit. Auditing Standard No. 15 omits protective language, such as "[u]nless the auditor has reason to believe the contrary, the auditor may accept records and document as genuine" that would weaken the requirement. This release includes additional discussion regarding this requirement.[483]

IAASB and ASB

The ISA states:

> Unless the auditor has reason to believe the contrary, the auditor may accept records and

[477] AU sec. 316.79.

[478] Section II.C.9.k.

[479] Section II.C.9.l.

[480] Ibid.

[481] Section II.C.9.m.

[482] Section II.C.10.c.

[483] Section II.C.10.e.

documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further.

The SAS includes a requirement similar to the ISA's requirement.

(iii). Selecting Items for Testing To Obtain Audit Evidence

PCAOB

Auditing Standard No. 15 states that the auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure. This requirement links the selection of items for testing to the sufficiency of the audit evidence. This release includes additional discussion of this requirement.[484]

IAASB and ASB

The ISA states:

> When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure.

The SAS includes a requirement similar to the ISA's requirement.

III. Date of Effectiveness of the Proposed Rules and Timing for Commission Action

Pursuant to Section 19(b)(2)(A)(ii) of the Securities Exchange Act of 1934 ("Exchange Act"), and based on its determination that an extension of the period set forth in Section 19(b)(2)(A)(i) of the Exchange Act is appropriate in light of the number and complexity of the standards to allow additional time sufficient for notice and comment, and consideration of comments, the Commission has determined to extend to *December 27, 2010* as the date by which the Commission should take action on the proposed rule.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule is consistent with the requirements of Title I of the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/pcaob.shtml*); or
- Send an e-mail to *rule-comments@sec.gov.* Please include File Number PCAOB–2010–01 on the subject line.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number PCAOB–2010–01. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/pcaob/shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule that are filed with the Commission, and all written communications relating to the proposed rule between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File No. PCAOB–2010–01 and should be submitted on or before October 18, 2010.

By the Commission.

Elizabeth M. Murphy,

Secretary.

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[484] Section II.C.10.j.