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PCAOB Standards and Related Rules As of January 2013

Public Company Accounting Oversight Board

American Institute of Certified Public Accountants (AICPA)

PCAOB Standards and Related Rules

As of January 2013

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PCAOB Standards and Related Rules

> Auditing Standards and Interim Standards

> PCAOB Staff Guidance

> Select Rules of the Board

> Select PCAOB Releases

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> Auditing Standards and Interim Standards

> PCAOB Staff Guidance

> Select Rules of the Board

> Select PCAOB Releases

AS OF JANUARY 2013

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This compilation contains certain standards and releases that have been adopted by the Public Company Accounting Oversight Board (PCAOB). This compilation also contains standards and other materials that have been adopted by the American Institute of Certified Public Accountants (AICPA). Pursuant to PCAOB rules, some of these AICPA materials, to the extent they have not been superseded or amended by the PCAOB, serve as the PCAOB's interim standards. If a provision of a PCAOB standard addresses a subject matter that also is addressed in the interim standards, the affected portion of the interim standard should be considered superseded or effectively amended. The organization and form of this publication is the work of the AICPA and has not been approved by, and does not represent the action of, the PCAOB.

Acknowledgments:

Auditing Standards
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Foreword

This compilation has been developed by the AICPA and contains the currently effective Public Company Accounting Oversight Board's (PCAOB's) professional standards (which consist of auditing, attestation, quality control, ethics, and independence standards) and related rules applicable to the preparation and issuance of audit reports for issuers, as defined by the Sarbanes-Oxley Act (act). In developing this compilation, the AICPA has updated the PCAOB's Interim Professional Auditing Standards (as described in PCAOB Release No. 2003-006 and contained in the "Interim Standards" section) to incorporate conforming amendments issued by the PCAOB and approved by the Securities and Exchange Commission (SEC) through the date of this compilation. Unless specifically stated in the standards of the PCAOB, the AICPA has not made conforming changes to the PCAOB's Interim Professional Auditing Standards to reflect the requirements and intent of standards issued by the PCAOB and approved by the SEC. Therefore, there may be conflicts between a PCAOB standard and the PCAOB's Interim Professional Auditing Standards; in which case the PCAOB standard should be followed.

Subject to SEC oversight, Section 103 of the act authorizes the PCAOB to establish auditing and related attestation, quality control, ethics, and independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports as required by the act or the rules of the SEC. Accordingly, public accounting firms registered with the PCAOB are required to adhere to all PCAOB standards in the audits of the financial statements of issuers, as defined by the act, and other entities when prescribed by the rules of the SEC.

Any registered public accounting firm or person associated with such a firm that fails to adhere to applicable PCAOB standards in connection with an audit of the financial statements of an issuer may be the subject of a PCAOB disciplinary proceeding in accordance with Section 105 of the act. In addition, the act provides that any violation of the PCAOB's rules is to be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934, 15 U.S.C. 78a et seq., or the rules and regulations issued thereunder, and any person violating the PCAOB's rules "shall be subject to the same penalties, and to the same extent, as for a violation of [the Exchange] Act or such rules or regulations."

Rule 201, *General Standards*, and Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 201 par. .01 and ET sec. 202 par. .01), of the AICPA Code of Professional Conduct, require a member who performs auditing and other professional services to comply with standards promulgated by bodies designated by AICPA Council. AICPA Council has designated the PCAOB as a body with the authority to promulgate auditing and related attestation standards, quality control, ethics, independence and other standards relating to the preparation and issuance of audit reports for issuers. The AICPA's Professional Ethics Division is able to hold an AICPA member who performs audits of the financial statements of issuers accountable under Rules 201 and 202 of the AICPA Code of Professional Conduct for complying with the PCAOB's auditing and related professional practice standards when performing such audits.

AUDITING STANDARDS RECENTLY ISSUED

Standard	Title
Auditing Standard No. 16	*Communications with Audit Committees*

In addition to the preceding standards, other changes to this edition of *PCAOB Standards and Related Rules* include the following:

Section	Change
Applicability of Public Company Accounting Oversight Board Standards and AICPA Professional Standards	Revision of part I, "Applicability of Public Company Accounting Oversight Board Standards and AICPA Professional Standards"
Applicability of Public Company Accounting Oversight Board Standards and AICPA Professional Standards	Revision of part II, "List of Selected Final PCAOB Auditing Standards and Rules"
Auditing Standards	Revisions to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, as identified in appendix 3 of PCAOB Release No. 2012-004, *Auditing Standard No. 16, Communications with Audit Committees; Related Amendments to PCAOB Standards; and Transitional Amendments to AU Sec. 380*
Auditing Standards	Revisions to Auditing Standard No. 9, *Audit Planning*, as identified in appendix 3 of PCAOB Release No. 2012-004
Auditing Standards	Revisions to Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, as identified in appendix 3 of PCAOB Release No. 2012-004
Auditing Standards	Addition of Topical Index
Interim Standards	Deletion of AU section 310, *Appointment of the Independent Auditor*, due to the issuance of Auditing Standard No. 16
Interim Standards	Revisions to AU section 316, *Consideration of Fraud in a Financial Statement Audit*, as identified in appendix 3 of PCAOB Release No. 2012-004
Interim Standards	Revisions to AU section 317, *Illegal Acts by Clients*, as identified in appendix 3 of PCAOB Release No. 2012-004

(continued)

Section	Change
Interim Standards	Revisions to AU section 328, *Auditing Fair Value Measurements and Disclosures*, as identified in appendix 3 of PCAOB Release No. 2012-004
Interim Standards	Revisions to AU section 333, *Management Representations*, as identified in appendix 3 of PCAOB Release No. 2012-004
Interim Standards	Revisions to AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, as identified in appendix 3 of PCAOB Release No. 2012-004
Interim Standards	Deletion of AU section 380, *Communication With Audit Committees*, due to the issuance of Auditing Standard No. 16
Interim Standards	Deletion of AU section 9380, *Communication With Audit Committees: Auditing Interpretations of Section 380*, as identified in appendix 3 of PCAOB Release No. 2012-004
Interim Standards	Revisions to AU section 532, *Restricting the Use of an Auditor's Report*, as identified in appendix 3 of PCAOB Release No. 2012-004
Interim Standards	Revisions to AU section 550, *Other Information in Documents Containing Audited Financial Statements*, as identified in appendix 3 of PCAOB Release No. 2012-004
Interim Standards	Revisions to AU section 711, *Filings Under Federal Securities Statutes*, as identified in appendix 3 of PCAOB Release No. 2012-004
Interim Standards	Revisions to AU section 722, *Interim Financial Information*, as identified in appendix 3 of PCAOB Release No. 2012-004
Interim Standards: U.S. Auditing	Addition of Topical Index
Interim Standards: Attestation Standards	Addition of Topical Index
Interim Standards: Code of Professional Conduct	Addition of Topical Index
Interim Standards: Independence Standards Board	Addition of Topical Index
Interim Standards: Quality Control	Addition of Topical Index

Section	Change
PCAOB Staff Guidance section 400.08	Addition of Staff Audit Practice Alert No. 8, *Audit Risks in Certain Emerging Markets*
PCAOB Staff Guidance section 400.09	Addition of Staff Audit Practice Alert No. 9, *Assessing and Responding to Risk in the Current Economic Environment*
PCAOB Staff Guidance section 400.10	Addition of Staff Audit Practice Alert No. 10, *Maintaining and Applying Professional Skepticism in Audits*
Select Rules of the Board	Addition of Topical Index
Select PCAOB Releases	Addition of PCAOB Release No. 2012-004

TABLE OF CONTENTS

SELECT PCAOB RELEASES—continued

Applicability of Public Company Accounting Oversight Board Standards and AICPA Professional Standards

TABLE OF CONTENTS

Part I

Applicability of Public Company Accounting Oversight Board Standards and AICPA Professional Standards

Background

As a result of the passage of the Sarbanes-Oxley Act of 2002 (the act), auditing and related professional practice standards to be used in the performance of and reporting on audits of the financial statements of public companies are now established by the Public Company Accounting Oversight Board (PCAOB). Note that the term *public companies* is a general reference to the entities subject to the securities laws. The act more specifically defines these entities as *issuers*, the definition of which is provided in the section that follows.

Among other significant provisions, the act requires a public accounting firm that prepares or issues, or participates in the preparation or issuance of, any audit report with respect to any issuer to register with the PCAOB. Accordingly, public accounting firms registered with the PCAOB are required to adhere to all PCAOB standards in the audits of issuers. Moreover, the act authorizes the PCAOB to establish auditing and related attestation, quality control, ethics, and independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports for issuers.

Who Is an Issuer?

As provided in Section 2 of the act, the term *issuer* means an issuer (as defined in Section 3 of the Securities Exchange Act of 1934 [15 U.S.C. 78c]), the securities of which are registered under Section 12 of that act (15 U.S.C. 78l) or that is required to file reports pursuant to Section 15(d) [15 U.S.C. 78o(d)], or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

Accordingly, nonissuers are those entities not subject to the act or the rules of the Securities and Exchange Commission (SEC). For audits of nonissuers, the preparation and issuance of audit reports must be conducted in accordance with the AICPA Code of Professional Conduct (AICPA Code) and the standards promulgated by the AICPA Auditing Standards Board (ASB). Audits of nonissuers remain governed by generally accepted auditing standards (GAAS) and the Statements on Quality Control Standards (SQCS) as issued by the ASB.

Standards Applicable to the Audits of *Issuers*

Rule 3100, *Compliance With Auditing and Related Professional Practice Standards*, issued by the PCAOB (see PCAOB Release No. 2003-009, dated June 30, 2003) generally requires all registered public accounting firms to adhere to the PCAOB's standards in connection with the preparation or issuance of any audit report on the financial statements of an issuer. Rule 3100 requires registered public accounting firms and their associated persons to comply with all applicable standards. Accordingly, if the PCAOB's standards do not apply to

an engagement or other activity of the firm, Rule 3100, by its own terms, does not apply to that engagement or activity.

Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*, issued by the PCAOB (see PCAOB Release No. 2004-007, dated June 9, 2004) defines the degree of responsibility imposed on the auditor by the use of certain terms in the PCAOB's auditing and related professional practice standards, including the interim standards adopted in Rule 3200T, *Interim Auditing Standards*; Rule 3300T, *Interim Attestation Standards*; Rule 3400T, *Interim Quality Control Standards*; Rule 3500T, *Interim Ethics Standards*; and Rule 3600T, *Interim Independence Standards* (further described in a later section). Effectively, Rule 3101 creates three categories of professional responsibilities:

1. *Unconditional responsibility*. The words *must*, *shall*, and *is required* indicate unconditional responsibilities. The auditor must fulfill responsibilities of this type in all cases in which the circumstances exist to which the requirement applies. Failure to discharge an unconditional responsibility is a violation of the relevant standard and Rule 3100.
2. *Presumptively mandatory responsibility*. The word *should* indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type specified in the PCAOB's standards unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard. Failure to discharge a presumptively mandatory responsibility is a violation of the relevant standard and Rule 3100 unless the auditor demonstrates that, in the circumstances, compliance with the specified responsibility was not necessary to achieve the objectives of the standard.
3. *Responsibility to consider*. The words *may*, *might*, *could*, and other terms and phrases describe actions and procedures that auditors have a responsibility to consider. Matters described in this fashion require the auditor's attention and understanding. How and whether the auditor implements these matters in the audit will depend on the exercise of professional judgment in the circumstances consistent with the objectives of the standard.

Compliance With Standards Applicable to the Audits of *Issuers*

Any registered public accounting firm or person associated with such a firm that fails to adhere to applicable PCAOB standards in connection with an audit of the financial statements of an issuer may be the subject of a PCAOB disciplinary proceeding in accordance with Section 105 of the act. In addition, the act provides that any violation of the PCAOB's rules is to be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934, 15 U.S.C. 78a et seq., or the rules and regulations issued thereunder, and any person violating the PCAOB's rules "shall be subject to the same penalties, and to the same extent, as for a violation of [the Exchange] Act or such rules or regulations."

Rule 201, *General Standards*, and Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 201 par. .01 and ET sec. 202 par. .01), of the AICPA Code require a member who performs auditing and other professional services to comply with standards promulgated by bodies designated by the AICPA Council. The AICPA Council has designated the PCAOB as the body

authorized to promulgate auditing and related attestation standards, quality control, ethics, independence and other standards relating to the preparation and issuance of audit reports for issuers.

The AICPA's Professional Ethics Division is able to hold an AICPA member who performs audits of the financial statements of issuers accountable under Rules 201 and 202 of the AICPA Code for complying with PCAOB's auditing and related professional practice standards when performing such audits.

Standards Applicable to the Audits of *Nonissuers*

With the formation of the PCAOB, the ASB was reconstituted and its jurisdiction amended to recognize the ASB as the body authorized to promulgate auditing, attestation and quality control standards relating to the preparation and issuance of audit reports for nonissuers.

Failure to follow ASB standards in the audit of a nonissuer would be considered a violation of Rule 201 or Rule 202 of the AICPA Code, or both.

As a caution to readers, pursuant to AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), interpretative publications are recommendations on the application of GAAS in specific circumstances, including engagements for entities in specialized industries. Interpretative publications, which include auditing interpretations, auditing guidance in AICPA Audit and Accounting Guides, and auditing guidance found in Statements of Position (SOPs), are issued under the authority of the ASB. The auditor should consider applicable interpretative publications in planning and performing the audit.

The ASB continues to issue SASs and interpretative publications that relate to audits of nonissuers and auditors should be alert to those issuances.

PCAOB's Adoption of Interim Standards

The PCAOB is subject to SEC oversight. As such, rules and standards issued by the PCAOB must be approved by the SEC before they become effective.

Pursuant to PCAOB Release No. 2003-006, dated April 18, 2003, the PCAOB adopted, on an initial, transitional basis, five temporary rules that refer to professional standards of auditing, attestation, quality control, ethics, and independence in existence on that date (known collectively as the Interim Professional Auditing Standards). The SEC granted approval to these rules (see SEC Release No. 33-8222, dated April 25, 2003).

Essentially, the interim standards that the PCAOB adopted were the auditing standards, attestation standards, quality control standards issued by the ASB, certain former AICPA SEC Practice Section (SECPS) membership requirements, certain AICPA ethics and independence rules, and Independence Standards Board (ISB) rules as they existed on April 16, 2003. These interim standards will remain in effect while the PCAOB conducts a review of standards applicable to registered public accounting firms. Based on this review, the PCAOB may modify, repeal, replace, or adopt, in part or in whole, the interim standards. As reiterated in a succeeding paragraph, the PCAOB's interim independence standards are not to be interpreted to supersede the SEC's independence requirements. The PCAOB has also made certain conforming amendments to the interim standards to reflect the adoption of PCAOB standards.

If a provision of a PCAOB standard addresses a subject matter that also is addressed in the interim standards, the affected portion of the interim standard should be considered superseded or effectively amended.

The five rules that comprise the PCAOB's interim standards consist of Rules 3200T, 3300T, 3400T, 3500T, and 3600T, and are described in the paragraphs that follow.

Rule 3200T—*Interim Auditing Standards*, as Amended by PCAOB Release No. 2003-026

Rule 3200T provides that, in connection with the preparation or issuance of any audit report on the financial statements of an issuer, a registered public accounting firm shall comply with GAAS as described in AU section 150,[1] as in existence on April 16, 2003, to the extent not superseded or amended by the PCAOB.

Rule 3300T—*Interim Attestation Standards*, as Amended by PCAOB Release No. 2003-026

Rule 3300T governs the conduct of engagements that (1) are described in the ASB's Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attest Engagements* (AT sec. 101), and (2) relate to the preparation or issuance of audit reports for issuers. Registered public accounting firms involved in such engagements are required to comply with the ASB's SSAEs, and related interpretations and AICPA SOPs, as in existence on April 16, 2003, to the extent not superseded or amended by the PCAOB.

Rule 3400T—*Interim Quality Control Standards*, as Amended by PCAOB Release No. 2003-026

Rule 3400T sets forth minimum quality control standards with which registered public accounting firms must comply, in order to ensure that registered public accounting firms, and their personnel, comply with applicable accounting and auditing (and other professional) standards. Pursuant to Rule 3400T, the PCAOB has provisionally designated the SQCSs (QC sections 20–40) proposed and issued by the ASB and certain former AICPA SECPS[2] membership requirements, as they existed, and as they applied to SECPS members, on April 16, 2003, to the extent not superseded or amended by the PCAOB, as the PCAOB's Interim Quality Control Standards.

Because the PCAOB intends the Interim Quality Control Standards (QC sections 20–40) to preserve existing standards as they applied on April 16, 2003 consistent with Section 103(a)(3) of the act, those Interim Quality Control Standards (QC sec. 20–40) adapted from the former AICPA SECPS requirements

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[1] Rule 3200T, *Interim Auditing Standards*, has not been amended to reflect references to the clarified standards. The guidance contained in extant AU section 150, is now addressed in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*).

[2] The Center for Audit Quality (CAQ) restructured and expanded the AICPA's Center for Public Company Audit Firms, which was the successor to the Securities and Exchange Commission Practice Section (SECPS). The CAQ, which began operating in January 2007, is an autonomous, nonpartisan, public policy organization affiliated with the AICPA and dedicated to enhancing investor confidence and public trust in the global capital markets by fostering high quality performance by auditors of public entities.

apply only to those firms that were members of the AICPA's SECPS on April 16, 2003.

Rule 3500T—*Interim Ethics Standards*, as Amended by PCAOB Release No. 2003-026

Rule 3500T sets forth ethical standards for registered public accounting firms and their personnel. Pursuant to Rule 3500T, the PCAOB has provisionally designated Rule 102, *Integrity and Objectivity*, and its interpretations and rulings thereunder (ET sec. 102 and 191) of the AICPA Code, as they existed on April 16, 2003, to the extent not superseded or amended by the PCAOB, as the PCAOB's Interim Ethics Standards.

Rule 3600T—*Interim Independence Standards*, as Amended by PCAOB Release No. 2003-026

Rule 3600T sets forth independence standards for registered public accounting firms and their personnel. Pursuant to Rule 3600T, the PCAOB has provisionally designated Rule 101, *Independence*, and its interpretations (ET sec. 101 and ET sec. 191) of the AICPA Code, as they existed on April 16, 2003, to the extent not superseded or amended by the PCAOB, and Standard Nos. 1, 2, and 3, and Interpretation Nos. 99-1, 00-1, and 00-2 of the ISB, to the extent not superseded or amended by the PCAOB, as the PCAOB's Interim Independence Standards. In addition, the PCAOB requires compliance with the SEC's independence rules. The PCAOB's Interim Independence Standards are not to be interpreted to supersede the SEC's independence requirements. Therefore, to the extent that a provision of the SEC's rule or policy is more restrictive—or less restrictive—than the PCAOB's Interim Independence Standards, a registered public accounting firm must comply with the more restrictive requirement.

References to GAAS

Auditing Standard No. 1 changed the requirement in the PCAOB's interim standards that the auditors include in their reports a reference to auditing standards promulgated by the ASB, examples of which include GAAS, U.S. GAAS, auditing standards generally accepted in the United States of America, and standards established by the AICPA. Instead, it requires that auditor's reports on the financial statements of issuers that are issued or reissued after the effective date of Auditing Standard No. 1 include a statement that the engagement was conducted in accordance with "the standards of the Public Company Accounting Oversight Board (United States)."

Conforming amendments resulting from Auditing Standard No. 1 have not yet been reflected in the PCAOB's interim standards. Such conforming changes will be made after the PCAOB issues, and the SEC approves, such conforming amendments.

Standards Applicable If a Nonissuer's Financial Statements Are Audited in Accordance With Both GAAS and PCAOB Auditing Standards

Paragraph .31 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), requires that the

auditor's report state that the audit was conducted in accordance with GAAS and identify the United States of America as the country of origin of those standards. However, as stated in paragraphs .42–.43 of AU-C section 700, an auditor may indicate that the audit was conducted in accordance with GAAS and another set of auditing standards (for example, International Standards on Auditing, PCAOB, or *Government Auditing Standards*). The auditor should not refer to having conducted an audit in accordance with another set of auditing standards in addition to GAAS, unless the audit was conducted in accordance with both sets of standards in their entirety. When the auditor's report refers to both GAAS and another set of auditing standards, the auditor's report should identify the other set of auditing standards, as well as their origin. Illustration 3 of AU-C section 700 provides example report language.

Standards Applicable to an Integrated Audit of a Nonissuer's Financial Statements

In October 2008, the ASB issued SSAE No. 15, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, AT sec. 501), which establishes standards and provides guidance to practitioners performing an examination of a nonissuer's internal control over financial reporting in the context of an integrated audit (an audit of an entity's financial statements and an examination of its internal control). SSAE No. 15 supersedes extant AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*, and converges the standards practitioners use for reporting on a nonissuer's internal control with PCAOB Auditing Standard No. 5.

AICPA Standards and the Audits of Issuers

If a registered public accounting firm performs an audit of *an issuer* in accordance with PCAOB standards, the auditor does not need to follow standards promulgated by the ASB. However, AICPA members are required to comply with the AICPA Code in addition to the ethics and independence rules and standards required by the SEC and PCAOB.

Part II

List of Selected Final PCAOB Auditing Standards and Rules

This table presents those standards and rules of the PCAOB that have been issued as final and are relevant to the standards contained in this publication. PCAOB standards and rules must be approved by the Securities and Exchange Commission (SEC) to be effective.

PCAOB Standards

SEC Approval Date	*Standard*	*Title*	*PCAOB Release Number*	*AU, AT, and ET Sections of PCAOB Standards Affected*
December 15, 2012	Auditing Standard No. 16	Communications with Audit Committees	2012-004	AU 310; 380
December 15, 2012	Conforming Amendments	Amendments to PCAOB Standards	2012-004	AU 316; 317; 328; 333; 341; 9380; 532; 550; 711; 722
December 23, 2010	Auditing Standard No. 15	Audit Evidence	2010-004	N/A
December 23, 2010	Auditing Standard No. 14	Evaluating Audit Results	2010-004	N/A
December 23, 2010	Auditing Standard No. 13	The Auditor's Responses to the Risks of Material Misstatement	2010-004	N/A
December 23, 2010	Auditing Standard No. 12	Identifying and Assessing Risks of Material Misstatement	2010-004	N/A
December 23, 2010	Auditing Standard No. 11	Consideration of Materiality in Planning and Performing an Audit	2010-004	N/A
December 23, 2010	Auditing Standard No. 10	Supervision of the Audit Engagement	2010-004	N/A
December 23, 2010	Auditing Standard No. 9	Audit Planning	2010-004	N/A
December 23, 2010	Auditing Standard No. 8	Audit Risk	2010-004	N/A
December 23, 2010	Conforming Amendments	Amendments to PCAOB Standards	2010-004	AU 110; 150; 210; 230; 310; 311; 9311; 312; 9312; 313; 315; 316; 317; 319; 322; 324; 326, 9326; 328; 329; 330; 332; 333; 334; 9334; 336; 9336; 341; 342; 9342; 350; 9350; 380; 411; 431; 508; 9508; 530; 543; 9543; 722 ET 102

(continued)

SEC Approval Date	*Standard*	*Title*	*PCAOB Release Number*	*AU, AT, and ET Sections of PCAOB Standards Affected*
January 15, 2010	Auditing Standard No. 7	Engagement Quality Review	2009-004	N/A
January 15, 2010	Conforming Amendments	Conforming Amendment to the Board's Interim Quality Control Standards	2009-004	QC 20
September 16, 2008	Auditing Standard No. 6	Evaluating Consistency of Financial Statements	2008-001	AU 420; 9420
September 16, 2008	Conforming Amendments	Conforming Amendments to PCAOB Interim Standards From the Adoption of Auditing Standard No. 6	2008-001	AU 328; 410; 411; 9411; 431; 508; 561
July 25, 2007	Auditing Standard No. 5	An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements	2007-005A	N/A
July 25, 2007	Conforming Amendments	Conforming Amendments to PCAOB Interim Standards From the Adoption of Auditing Standard No. 5	2007-005A	AU 230; 310; 311; 312; 313; 315; 316; 319; 322; 324; 325; 9325; 328; 332; 333; 9337; 341; 342; 380; 508; 530; 543; 560; 561; 711; 722
February 6, 2006	Auditing Standard No. 4	Reporting on Whether a Previously Reported Material Weakness Continues to Exist	2005-015	N/A
February 6, 2006	Conforming Amendments	Conforming Amendments to PCAOB Interim Standards Resulting From the Adoption of PCAOB Auditing Standard No. 4	2005-015	AT 101
August 25, 2004	Auditing Standard No. 3	Audit Documentation	2004-006	AU 339
August 25, 2004	Amendment to Interim Auditing Standards	Part of Audit Performed by Other Independent Auditors	2004-006	AU 543
April 28, 2004	Auditing Standard No. 1	References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board	2003-025	AU 508

PCAOB Rules

SEC Approval Date	*Rule*	*Title*	*PCAOB Release Number*
August 22, 2008	Rule 3526	Communication with Audit Committees Concerning Independence	2008-003
July 25, 2007	Rule 3525	Audit Committee Pre-Approval of Non-audit Services Related to Internal Control Over Financial Reporting	2007-005A
April 19, 2006	Rules 3501, 3502, 3520, 3521, 3522, 3523, and 3524	Technical Amendments to Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees	2005-020
April 19, 2006	3501, 3502, 3520, 3521, 3522, 3523, and 3524	Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees	2005-014
September 8, 2004	Rule 3101	Certain Terms Used in Auditing and Related Professional Practice Standards and an Amendment to Rule 1001, Definitions of Terms Employed in Rules	2004-007
April 28, 2004	Amendment to Rule 3200T	Technical Amendments to Interim Standards Rules	2003-026
April 28, 2004	Amendment to Rule 3300T	Technical Amendments to Interim Standards Rules	2003-026
April 28, 2004	Amendment to Rule 3400T	Technical Amendments to Interim Standards Rules	2003-026
April 28, 2004	Amendment to Rule 3500T	Technical Amendments to Interim Standards Rules	2003-026
April 28, 2004	Amendment to Rule 3600T	Technical Amendments to Interim Standards Rules	2003-026
April 28, 2004	Rule 3100	Compliance With Auditing and Related Professional Practice Standards	2003-009
April 25, 2003	Rule 3200T	Interim Auditing Standards	2003-006
April 25, 2003	Rule 3300T	Interim Attestation Standards	2003-006
April 25, 2003	Rule 3400T	Interim Quality Control Standards	2003-006
April 25, 2003	Rule 3500T	Interim Ethics Standards	2003-006
April 25, 2003	Rule 3600T	Interim Independence Standards	2003-006

Auditing Standards

AUDITING STANDARDS

Auditing Standard No. 1

References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board

[Effective pursuant to SEC Release No. 34-49707; File No. PCAOB-2003-10, May 14, 2004; effective for audit reports issued or reissued on or after May 24, 2004.]

1. The Sarbanes-Oxley Act of 2002 authorized the Public Company Accounting Oversight Board ("PCAOB") to establish auditing and related professional practice standards to be used by registered public accounting firms. PCAOB Rule 3100, *Compliance With Auditing and Related Professional Practice Standards*, requires the auditor to comply with all applicable auditing and related professional practice standards of the PCAOB.

2. The Board has adopted as interim standards, on an initial, transitional basis, the generally accepted auditing standards, described in the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, in existence on April 16, 2003.[1]

3. Accordingly, in connection with any engagement performed in accordance with the auditing and related professional practice standards of the PCAOB, whenever the auditor is required by the interim standards to make reference in a report to generally accepted auditing standards, U.S. generally accepted auditing standards, auditing standards generally accepted in the United States of America, or standards established by the AICPA, the auditor must instead refer to "the standards of the Public Company Accounting Oversight Board (United States)." An auditor must also include the city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued.

4. This auditing standard is effective for auditors' reports issued or reissued on or after the 10th day following approval of this auditing standard by the Securities and Exchange Commission.

5. Audit reports issued prior to the effective date of this standard were required to state that the audits that supported those reports were performed in accordance with generally accepted auditing standards. The PCAOB adopted those generally accepted auditing standards, including their respective effective dates, as they existed on April 16, 2003, as interim standards. Therefore, reference to "the standards of the Public Company Accounting Oversight Board (United States)" with respect to audits of financial statements performed prior to the effective date of this standard is equivalent to the previously-required reference to generally accepted auditing standards. Accordingly, upon adoption of this standard, a reference to generally accepted auditing standards in auditors' reports is no longer appropriate or necessary.

Note: The term "auditor" in this standard is intended to include both registered public accounting firms and associated persons thereof.

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[1] The Board's rules on interim standards were adopted by the Board on April 16, 2003, and approved by the Commission on April 25, 2003. See SEC Rel. No. 33-8222 (April 25, 2003).

Appendix

Illustrative Reports

1. The following is an illustrative report on an audit of financial statements:

Report of Independent Registered Public Accounting Firm

We have audited the accompanying balance sheets of X Company as of December 31, 20X3 and 20X2, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 20X3. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of [*at*] December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X3, in conformity with U.S. generally accepted accounting principles.

[*Signature*]

[City and State or Country]

[*Date*]

2. The following is an illustrative report on a review of interim financial information:

Report of Independent Registered Public Accounting Firm

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of X Company as of September 30, 20X3 and 20X2, and for the three-month and nine-month periods then ended. This (these) interim financial information (statements) is (are) the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial (statements) for it (them) to be in conformity with U.S. generally accepted accounting principles.

[*Signature*]

[City and State or Country]

[*Date*]

Attachment

PCAOB Release No. 2003-025

December 17, 2003
PCAOB Rulemaking
Docket Matter No. 010

Approved by the Securities and Exchange Commission on May 14, 2004, and is effective for audit reports issued or reissued on or after May 24, 2004.

Summary

After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") has adopted Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*. This standard requires registered public accounting firms to include in their reports on engagements performed pursuant to the Board's auditing and related professional practice standards, including audits and reviews of financial statements, a reference to the standards of the Public Company Accounting Oversight Board (United States). The Board will submit this standard to the Securities and Exchange Commission ("Commission" or "SEC") for approval pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 (the "Act"). This standard will not take effect unless approved by the Commission.

Board Contacts

Thomas Ray, Deputy Chief Auditor (202/207-9112; rayt@pcaobus.org), Greg Scates, Associate Chief Auditor (202/207-9114; scatesg@pcaobus.org).

* * * * * *

Section 103 of the Act authorizes the PCAOB to establish auditing and related professional practice standards to be used by registered public accounting firms in connection with the preparation and issuance of audit reports as required by the Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors. Consistent with Section 103 of the Act, PCAOB Rule 3100, *Compliance With Auditing and Related Professional Practice Standards*, requires auditors to comply with all applicable auditing and related professional practice standards established by the PCAOB.

Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* directs auditors[1] to state that the engagement was conducted in accordance with "the standards of the Public Company Accounting Oversight Board (United States)" whenever the auditor has performed the engagement in accordance with the Board's standards.

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[1] Reference in the Board's standards to an "auditor" means a registered public accounting firm, or an associated person of such a firm, as defined in the Act and the Board's rules, unless specifically stated otherwise. Nothing in the Board's rules would preclude an accounting firm from conducting an audit of a company that is not an issuer in accordance with the Board's standards and so stating in its audit report. This is true regardless of whether or not the accounting firm performing the audit is registered with the Board.

Section A of this release describes Auditing Standard No. 1. Section B of this release discusses and addresses the comments received on the Board's proposed auditing standard, which the Board released for public comment. The text of Auditing Standard No. 1 is attached to this release as Appendix 1.

A. Description of Auditing Standard No. 1

At the time of this release, the Board's auditing and related professional practice standards consist of the standards described in Rules 3200T through 3600T, which the Board has adopted, on an initial, transitional basis, as interim standards. The standards (with which PCAOB Rule 3100 requires registered public accounting firms, and persons associated with such firms, to comply) include these interim standards and any permanent standards that the Board adopts.

Each of the standards described in Rules 3200T through 3600T was originally adopted by the American Institute of Certified Public Accountants ("AICPA"), a committee thereof, including the Auditing Standards Board ("ASB"), or the Independence Standards Board. Thus the Board's rule on interim auditing standards, Rule 3200T, incorporates "generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, in existence on April 16, 2003" (the "interim standards").[2] These auditing standards were adopted, and from time to time amended, by the ASB, until the Board incorporated them into the Board's interim standards. The interim standards require auditors to include in their reports a reference to the standards that were followed in performing the engagement. These references include "generally accepted auditing standards," "U.S. generally accepted auditing standards," "auditing standards generally accepted in the United States of America," and "standards established by the AICPA."

PCAOB Auditing Standard No. 1 supersedes these references by requiring that auditors' reports on the financial statements of issuers that are issued or reissued, after Auditing Standard No. 1 becomes effective, include a statement that the engagement was conducted in accordance with "the standards of the Public Company Accounting Oversight Board (United States)."[3] This auditing standard is effective for auditors' reports issued or reissued on or after the 10th day following approval of this auditing standard by the Commission. An appendix[4] to this standard provides illustrative reports on an audit of financial statements and a review[5] of interim financial information of a public company.

Once Auditing Standard No. 1 becomes effective, it will require auditors to state that the engagement was performed in accordance with "the standards of the Public Company Accounting Oversight Board (United States)," irrespective of whether the engagement was conducted before or after Auditing Standard No. 1 becomes effective. Accordingly, auditors who reissue reports that were originally issued before the date that Auditing Standard No. 1 becomes effective, or who issue reports that include comparative financial information that

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[2] The Board's rules on interim standards were adopted by the Board on April 16, 2003, and approved by the Commission on April 25, 2003. See SEC Rel. No. 33-8222 (April 25, 2003).

[3] See Auditing Standard No. 1 ¶ 3.

[4] Appendices to the Board's standards are an integral part of the standard and carry the same authoritative weight as the body of the standard.

[5] Reviews of the interim financial information are integrally related to audits of financial statements. See generally Statement on Auditing Standards No. 100, *Interim Financial Information* ("SAS No. 100"). For example, SAS No. 100 makes clear that the general standards on auditing discussed in SAS No. 95 "are applicable to a review of interim financial information."

was the subject of an audit or review report that was issued before that date, must nevertheless state that the audit or review was performed in accordance with "the standards of the Public Company Accounting Oversight Board (United States)," if those reports are reissued after Auditing Standard No. 1 becomes effective. The Board believes that a uniform reference to the standards of the PCAOB—even with respect to audits and reviews completed before the PCAOB adopted its interim standards—is appropriate because the interim standards that the Board adopted are the "generally accepted auditing standards" with which auditors were required to comply before the PCAOB adopted its interim standards.

Referring to PCAOB standards in connection with a period that preceded the date of the PCAOB's own adoption of those standards may seem somewhat counterintuitive. The requirement is intended, however, to reflect the fact that the standards in place before the PCAOB adopted its interim standards, without change, became the PCAOB's standards. Indeed, the Board considered whether to require auditors to refer to "generally accepted auditing standards" when reissuing reports that were originally issued before Auditing Standard No. 1 becomes effective, and to refer to "standards of the PCAOB" with respect to reports issued on or after Auditing Standard No. 1 becomes effective.

The Board believes, however, that it is appropriate to describe the "generally accepted auditing standards" that the Board adopted as "standards of the PCAOB." This terminology will reflect the fact that the standards that auditors were required to use before April 25, 2003—i.e., generally accepted auditing standards as they existed on April 16, 2003—became the applicable standards on April 25 and continue to apply to audits of public companies, as the Board amends them. Auditing standards have continuously been amended over time, and auditors have consistently been required to state whether their audits complied with the then-prevailing standards. The substance of the applicable standards for audits and reviews of public company financial statements did not change on April 25, 2003. Rather, April 25, 2003, is significant only because the PCAOB gained authority over such standards on that date. The Board believes it would be inappropriate to create an impression in auditors' reports that engagements performed before Auditing Standard No. 1 becomes effective, or even before April 25, were performed in accordance with a wholly different body of standards, rather than the same body of standards at different points in its evolution.

The Board expects to amend its standards from time to time, just as the ASB amended generally accepted auditing standards from time to time. The Board believes that using a consistent description of standards prevailing at the time an audit or review report is issued—and holding auditors to compliance with those then-prevailing standards—better contributes to the creation of informative audit reports.

Upon adoption of this auditing standard, all references in the interim standards to generally accepted auditing standards, U.S. generally accepted auditing standards, auditing standards generally accepted in the United States of America, and standards established by the AICPA, mean the corresponding standards of the Public Company Accounting Oversight Board. The Act and the Board's rules already require the auditor to comply with the Board's standards. The purpose of this standard is to conform the references in the interim standards to the standards that the Act and Rule 3100 require auditors to use in connection with preparing and issuing audit and related reports on the financial statements of issuers.

Under the Act, Auditing Standard No. 1 will not be effective unless it is approved by the SEC. By its terms, Auditing Standard No. 1 will be effective for auditors'

reports issued or reissued on or after the 10th day following SEC approval of this standard. Until the effective date of this standard, the reporting requirements as described in the AICPA's Codification of Statements on Auditing Standards, are still in effect as interim standards.

B. Public Comment Process and Board Responses

The Board released a proposed auditing standard, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*, for public comment, on November 12, 2003. The Board received eight written comment letters.[6] In response to these comments, the Board's final rules both clarify and modify certain aspects of the proposal, as explained below.

1. Transitional Issues

The Board received several comments related to transitional issues, including, how the proposed standard would affect—

- reissuance of a report originally issued before the proposed standard became effective;
- issuance of a report on comparative financial statements when the audits of the financial statements for periods presented for comparative purposes were conducted before the proposed standard became effective and/or before the Board adopted its interim standards; and
- issuance of a dual-dated report that include dates that straddle the effective date of this standard.

In the proposed standard, the Board had recommended the standard be effective for auditors' reports dated on or after the later of January 1, 2004 or the 10th day after SEC approval of the standard as adopted by the Board. In evaluating the comments with regard to transition, the Board decided to modify the effective date of this standard. Rather than linking the effective date of this standard to the date of the report, this auditing standard will be effective for reports issued or reissued on or after the 10th day following SEC approval of this auditing standard. After this standard becomes effective, any auditor's report issued or reissued with respect to the financial statements of a public company must state that the engagement was performed in accordance with "the standards of the Public Company Accounting Oversight Board (United States)."

One commenter also expressed concern that the proposed standard's requirement that a report state that an audit performed prior to the PCAOB's adoption of interim standards was performed in accordance with PCAOB standards would, in essence, require the auditor to re-audit the prior period's financial statements in order to bring that audit or review into conformity with current PCAOB standards. The Board does not intend to require auditors to bring audits that were performed in accordance with then-prevailing standards into conformity with later-prevailing standards in order to reissue a previously-issued report. When the Board adopted as interim standards the generally accepted auditing standards established by the ASB, the Board also adopted the effective dates of those standards. Therefore, reference in auditors' reports to the standards of the PCAOB with respect to financial statements audited or reviewed prior to the effective date of Auditing Standard No. 1 is equivalent

[6] The comment letters are available on the Board's Web site—www.pcaobus.org—and will be attached to the Board's Form 19b-4, to be filed with the Commission.

to the previously-required reference to generally accepted auditing standards. The reference relates to those standards that were in effect when the audit or review was completed and should not be interpreted to imply a representation that the audit or review complied with standards that became effective after the audit or review was completed. Thus, once Auditing Standard No. 1 becomes effective, a reference to generally accepted auditing standards in reports issued in connection with financial statements of public companies is no longer appropriate or necessary.

2. Applicable Standards of the PCAOB

Several commenters recommended that the Board only require auditors' reports to refer to the *auditing* standards of the PCAOB for audits of financial statements and not to the standards of the PCAOB generally. The Board intends for report references to "the standards of the Public Company Accounting Oversight Board (United States)" to mean those auditing and related professional practice standards that are applicable to the particular engagement. For example, if an issuer does not use any outside service organization that would affect its internal control over financial reporting, then the interim auditing standard on service organizations—described in the Codification of Statements on Auditing Standards at AU § 324 (*Service Organizations*), would not be applicable. On the other hand, the Board's independence standards apply to registered public accounting firms, and associated persons thereof, in connection with the preparation and issuance of audit reports for issuers.

As another example, quality control standards generally apply to a firm's system of quality control over its accounting and auditing practice and not to individual audit engagements. Thus, a breakdown in the system of quality control does not necessarily mean that a particular audit was not conducted in accordance with the standards of the PCAOB. However, such a breakdown might result in a deficient audit if it caused or contributed to an audit deficiency. The determination as to whether a particular auditing or related professional practice standard is applicable in the context of a particular audit is dependent on the nature of the standard in question and on the nature of the engagement at issue.

Thus a reference to "auditing standards" of the PCAOB would be too narrow and preclusive to other standards applicable to the audit. The Board believes that reference to "the standards of the Public Company Accounting Oversight Board (United States)" is a more descriptive reference to the standards applied in the audit.

3. Reference to GAAS

The Board received a number of comments recommending that auditors' reports, with respect to financial statement audits, describe PCAOB standards as generally accepted auditing standards. The notion of general acceptance developed at a time when auditing and accounting standards were not established with the force of law by governmental or other authoritative bodies, but rather were established by consensus among the members of the accounting profession.

As far as auditing and related professional practice standards are concerned, the Board gained authority to establish such standards by the enactment of the Act. Professional consensus is no longer sufficient to establish auditing standards, and therefore the Board believes that it is no longer appropriate to refer to the standards with which an auditor of the financial statements of a public company must comply as "generally accepted." While those standards

may be generally accepted in a variety of contexts, what gives them the force of law in the context of public company audits is adoption by the PCAOB and approval by the SEC.

Therefore, for purposes of any engagement performed in accordance with the applicable auditing and related professional practice standards of the PCAOB, references in the interim standards to generally accepted auditing standards, U.S. generally accepted auditing standards, auditing standards generally accepted in the United States of America, and standards established by the AICPA, mean the standards of the PCAOB.

4. References to Country of Origin and Issuing Office

The Board also received comments recommending that the Board continue to require auditors to state in their reports that the standards according to which they performed their engagements were those standards applicable in the United States. Adopting this recommendation will make it easier for readers of audit reports that are used in cross-border offerings and listings of securities to quickly identify the jurisdiction in which the standards were promulgated. As such, the Board has required in Auditing Standard No. 1 that auditors' reports describe the PCAOB's standards as "the standards of the Public Company Accounting Oversight Board (United States)."

Another commenter recommended that auditors identify in their reports the city and state (or country) of the registered firms issuing the reports. The SEC's rules require disclosure in the auditor's report of the city and state of the accounting firm's office issuing the report.[7] The Board also concurs with this recommendation and, accordingly, has modified the auditing standard and the illustrative reports in the appendix to Auditing Standard No. 1.

5. Other Auditors

The Board was asked to clarify the applicability of this standard, and the Board's standards generally, to circumstances where more than one auditing firm contributes to an audit of a consolidated entity. For example, a firm other than the firm engaged to report on the company's consolidated financial statements may be hired to audit the financial statements of a subsidiary company. In such circumstances, the auditor that conducts the majority of the audit is referred to as the principal auditor and the auditor of the subsidiary company is referred to as the other auditor.[8] Depending on the significance of the portion of the financial statements audited by the other auditor, the principal auditor may divide responsibility with the other auditor by making reference to the audit of the other auditor in his or her report, or the principal auditor may take responsibility for the work of the other auditor by not making any reference to the other auditor.

In either event, the entire audit must be performed in accordance with the Board's standards. Section 103 of the Act, and the Board's Rule 3100, require registered public accounting firms, and associated persons thereof, to comply with all applicable auditing and related professional practice standards in connection with the preparation and issuance of audit reports on the financial statements of issuers. Whether the other auditor is a registered public accounting firm or an associated person of a registered public accounting firm, the other auditor must comply with the standards of the PCAOB.

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[7] 17 C.F.R. § 210.2-02 (2003).

[8] See Codification of Auditing Standards, AU § 543 (AICPA 2002).

6. Applicability to Non-U.S. Firms Not Yet Registered With the Board

Another commenter asked the Board to clarify whether non-U.S. public accounting firms—who are not required to register with the PCAOB until 2004—will be permitted, until registered with the PCAOB, to continue to reference "auditing standards generally accepted in the United States of America" when reporting on an issuer's financial statements. Like the Board's interim standards, with which a public accounting firm is required to comply even before the firm's mandatory registration date, during the period preceding the mandatory registration date, standards of the PCAOB apply to firms engaged in work that requires their registration. Therefore, non-U.S. public accounting firms that have not yet registered, that engage in work that would require them to be registered as of the mandatory registration date, are nevertheless required to reference "the standards of the Public Company Accounting Oversight Board (United States)."

7. Application of Auditing Standard No. 1 to Audit Reports in Connection With Initial Public Offerings

Another commenter recommended that the Board expand the proposed standard to specifically address the various scenarios that auditors will encounter with respect to reporting in conjunction with initial public offerings. The SEC's Rule 3-01 of Regulation S-X requires that, like other SEC filings that must comply with Regulation S-X, a registration statement filed in connection with an initial public offering must include or otherwise incorporate "for the registrant and its subsidiaries consolidated, audited balance sheets as of the end of each of the two most recent fiscal years."[9] In addition, Rule 3-02 of Regulation S-X requires that there "be filed, for the registrant and its subsidiaries consolidated and for its predecessors, audited statements of income and cash flows for each of the three fiscal years preceding the date of the most recent audited balance sheet."[10] The Board understands these provisions to mean that an issuer desiring to register a transaction involving the sale of securities must include balance sheets for the two years preceding the transaction, and income statements and statements of cash flows for the three years preceding the transaction, each audited in accordance with standards as required by the securities laws.

In Section 103 of the Act, Congress has provided the Board authority to establish auditing and related professional practice standards "to be used by registered public accounting firms in the preparation and issuance of audit reports." In addition, the PCAOB has adopted, and the SEC has approved, PCAOB Rule 3100, which requires registered public accounting firms to comply with all applicable auditing and related professional practice standards of the PCAOB in connection with the preparation and issuance of audit reports on the financial statements of issuers. Accordingly, audit reports on the financial statements of issuers must now comply with—and under Auditing Standard No. 1 auditors must state that they performed the audit in accordance with—the standards of the PCAOB. So long as audits that were performed prior to April 25, 2003, were performed in accordance with then-prevailing generally accepted auditing standards as required by Rule 2-02 of Regulation S-X, an auditor need not reaudit any financial statements that relate to periods preceding April 25, 2003. Further, as discussed above, because the Board adopted the "generally accepted auditing standards" in effect as of April 16, 2003, the Board believes

[9] 17 C.F.R. § 210.3-01 (2003).

[10] 17 C.F.R. § 210.3-02 (2003).

it is appropriate to require auditors who issue or reissue reports on periods prior to the date Auditing Standard No. 1 becomes effective to state that their audits were performed in accordance with PCAOB standards, so long as they were performed in accordance with the "generally accepted auditing standards" prevailing at the time the audits were performed.

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On the 17th day of December, in the year 2003, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Acting Secretary
December 17, 2003

APPENDIX—

References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board

Appendix

References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board

[Appendix omitted; see Auditing Standard No. 1 for the full text of the standard.]

Auditing Standard No. 3
Audit Documentation

[Supersedes SAS No. 96, *Audit Documentation*]

Source: Auditing Standard Nos 8–15.

[Effective pursuant to SEC Release No. 34-50253; File No. PCAOB-2004-05, August 25, 2004; effective for audits of financial statements with respect to fiscal years ending on or after November 15, 2004. For other engagements conducted pursuant to the standards of the PCAOB, including reviews of interim financial information, this standard takes effect beginning with the first quarter ending after the first financial statement audit covered by this standard.]

Introduction

1. This standard establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to the standards of the Public Company Accounting Oversight Board ("PCAOB"). Such engagements include an audit of financial statements, an audit of internal control over financial reporting, and a review of interim financial information. This standard does not replace specific documentation requirements of other standards of the PCAOB.

Objectives of Audit Documentation

2. *Audit documentation* is the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise. Audit documentation also facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Among other things, audit documentation includes records of the planning and performance of the work, the procedures performed, evidence obtained, and conclusions reached by the auditor. Audit documentation also may be referred to as *work papers* or *working papers*.

> Note: An auditor's representations to a company's board of directors or audit committee, stockholders, investors, or other interested parties are usually included in the auditor's report accompanying the financial statements of the company. The auditor also might make oral representations to the company or others, either on a voluntary basis or if necessary to comply with professional standards, including in connection with an engagement for which an auditor's report is not issued. For example, although an auditor might not issue a report in connection with an engagement to review interim financial information, he or she ordinarily would make oral representations about the results of the review.

3. *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Audit documentation is reviewed by members of the engagement team performing the work and might be reviewed by others. Reviewers might include, for example:

a. Auditors who are new to an engagement and review the prior year's documentation to understand the work performed as an aid in planning and performing the current engagement.

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

c. Engagement supervisors and engagement quality reviewers who review documentation to understand how the engagement team reached significant conclusions and whether there is adequate evidential support for those conclusions.

d. A successor auditor who reviews a predecessor auditor's audit documentation.

e. Internal and external inspection teams that review documentation to assess audit quality and compliance with auditing and related professional practice standards; applicable laws, rules, and regulations; and the auditor's own quality control policies.

f. Others, including advisors engaged by the audit committee or representatives of a party to an acquisition.

Audit Documentation Requirement

4. The auditor must prepare audit documentation in connection with each engagement conducted pursuant to the standards of the PCAOB. Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. Also, the documentation should be appropriately organized to provide a clear link to the significant findings or issues.[1] Examples of audit documentation include memoranda, confirmations, correspondence, schedules, audit programs, and letters of representation. Audit documentation may be in the form of paper, electronic files, or other media.

5. Because audit documentation is the written record that provides the support for the representations in the auditor's report, it should:

a. Demonstrate that the engagement complied with the standards of the PCAOB,

b. Support the basis for the auditor's conclusions concerning every relevant financial statement assertion, and

c. Demonstrate that the underlying accounting records agreed or reconciled with the financial statements.

6. The auditor must document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions.[2] Audit documentation must clearly demonstrate that the work was in fact performed. This documentation requirement applies to the work of all those who participate in the engagement as well as to the work of specialists the auditor uses as evidential matter in evaluating relevant financial statement

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[1] See paragraph 12 of this standard for a description of significant findings or issues.

[2] *[The following footnote is effective November 15, 2007. See PCAOB Release 2007-005.] Relevant financial statement assertions* are described in paragraphs 28–33 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

assertions. Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement:

a. To understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and

b. To determine who performed the work and the date such work was completed as well as the person who reviewed the work and the date of such review.

Note: An *experienced auditor* has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry.

7. In determining the nature and extent of the documentation for a financial statement assertion, the auditor should consider the following factors:

- Nature of the auditing procedure;
- Risk of material misstatement associated with the assertion;
- Extent of judgment required in performing the work and evaluating the results, for example, accounting estimates require greater judgment and commensurately more extensive documentation;
- Significance of the evidence obtained to the assertion being tested; and
- Responsibility to document a conclusion not readily determinable from the documentation of the procedures performed or evidence obtained.

Application of these factors determines whether the nature and extent of audit documentation is adequate.

8. In addition to the documentation necessary to support the auditor's final conclusions, audit documentation must include information the auditor has identified relating to significant findings or issues that is inconsistent with or contradicts the auditor's final conclusions. The relevant records to be retained include, but are not limited to, procedures performed in response to the information, and records documenting consultations on, or resolutions of, differences in professional judgment among members of the engagement team or between the engagement team and others consulted.

9. If, after the documentation completion date (defined in paragraph 15), the auditor becomes aware, as a result of a lack of documentation or otherwise, that audit procedures may not have been performed, evidence may not have been obtained, or appropriate conclusions may not have been reached, the auditor must determine, and if so demonstrate, that sufficient procedures were performed, sufficient evidence was obtained, and appropriate conclusions were reached with respect to the relevant financial statement assertions. To accomplish this, the auditor must have persuasive other evidence. Oral explanation alone does not constitute persuasive other evidence, but it may be used to clarify other written evidence.

- If the auditor determines and demonstrates that sufficient procedures were performed, sufficient evidence was obtained, and appropriate conclusions were reached, but that documentation thereof is not adequate, then the auditor should consider what additional documentation is needed. In preparing additional documentation, the auditor should refer to paragraph 16.

- If the auditor cannot determine or demonstrate that sufficient procedures were performed, sufficient evidence was obtained, or appropriate conclusions were reached, the auditor should comply with the provisions of AU sec. 390, *Consideration of Omitted Procedures After the Report Date*.

9A. *[The following paragraph is added and effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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.

Documentation of Specific Matters

10. Documentation of auditing procedures that involve the inspection of documents or confirmation, including tests of details, tests of operating effectiveness of controls, and walkthroughs, should include identification of the items inspected. Documentation of auditing procedures related to the inspection of significant contracts or agreements should include abstracts or copies of the documents.

Note: The identification of the items inspected may be satisfied by indicating the source from which the items were selected and the specific selection criteria, for example:

- If an audit sample is selected from a population of documents, the documentation should include identifying characteristics (for example, the specific check numbers of the items included in the sample).
- If all items over a specific dollar amount are selected from a population of documents, the documentation need describe only the scope and the identification of the population (for example, all checks over $10,000 from the October disbursements journal).
- If a systematic sample is selected from a population of documents, the documentation need only provide an identification of the source of the documents and an indication of the starting point and the sampling interval (for example, a systematic sample of sales invoices was selected from the sales journal for the period from October 1 to December 31, starting with invoice number 452 and selecting every 40th invoice).

11. Certain matters, such as auditor independence, staff training and proficiency and client acceptance and retention, may be documented in a central repository for the public accounting firm ("firm") or in the particular office participating in the engagement. If such matters are documented in a central repository, the audit documentation of the engagement should include a reference to the central repository. Documentation of matters specific to a particular engagement should be included in the audit documentation of the pertinent engagement.

12. *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor must document significant findings or issues, actions taken to address them (including additional evidence obtained), and the basis for the

conclusions reached in connection with each engagement. *Significant findings or issues* are substantive matters that are important to the procedures performed, evidence obtained, or conclusions reached, and include, but are not limited to, the following:

a. Significant matters involving the selection, application, and consistency of accounting principles, including related disclosures.[2A]

b. 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.

c. Accumulated misstatements and evaluation of uncorrected misstatements, including the quantitative and qualitative factors the auditor considered to be relevant to the evaluation.[2B]

d. 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.

e. Circumstances that cause significant difficulty in applying auditing procedures.

f. 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.[2C]

f-1. Risks of material misstatement that are determined to be significant risks and the results of the auditing procedures performed in response to those risks.

g. Any matters that could result in modification of the auditor's report.

13. The auditor must identify all significant findings or issues in an *engagement completion document*. This document may include either all information necessary to understand the significant findings, issues or cross-references, as appropriate, to other available supporting audit documentation. This document, along with any documents cross-referenced, should collectively be as specific as necessary in the circumstances for a reviewer to gain a thorough understanding of the significant findings or issues.

Note: The engagement completion document prepared in connection with the annual audit should include documentation of significant findings or issues identified during the review of interim financial information.

[2A] 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*. *[Footnote added, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[2B] See paragraphs 10–23 of Auditing Standard No. 14, *Evaluating Audit Results*. *[Footnote added, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[2C] 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*. *[Footnote added, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Retention of and Subsequent Changes to Audit Documentation

14. The auditor must retain audit documentation for seven years from the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements (*report release date*), unless a longer period of time is required by law. If a report is not issued in connection with an engagement, then the audit documentation must be retained for seven years from the date that fieldwork was substantially completed. If the auditor was unable to complete the engagement, then the audit documentation must be retained for seven years from the date the engagement ceased.

15. Prior to the report release date, the auditor must have completed all necessary auditing procedures and obtained sufficient evidence to support the representations in the auditor's report. A complete and final set of audit documentation should be assembled for retention as of a date not more than 45 days after the report release date (*documentation completion date*). If a report is not issued in connection with an engagement, then the documentation completion date should not be more than 45 days from the date that fieldwork was substantially completed. If the auditor was unable to complete the engagement, then the documentation completion date should not be more than 45 days from the date the engagement ceased.

16. Circumstances may require additions to audit documentation after the report release date. Audit documentation must not be deleted or discarded after the documentation completion date, however, information may be added. Any documentation added must indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it.

17. Other standards require the auditor to perform procedures subsequent to the report release date in certain circumstances. For example, in accordance with AU sec. 711, *Filings Under Federal Securities Statutes*, auditors are required to perform certain procedures up to the effective date of a registration statement.[3] The auditor must identify and document any additions to audit documentation as a result of these procedures consistent with the previous paragraph.

18. The office of the firm issuing the auditor's report is responsible for ensuring that all audit documentation sufficient to meet the requirements of paragraphs 4–13 of this standard is prepared and retained. Audit documentation supporting the work performed by other auditors (including auditors associated with other offices of the firm, affiliated firms, or non-affiliated firms), must be retained by or be accessible to the office issuing the auditor's report.[4]

19. *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

In addition, the office issuing the auditor's report must obtain, and review and retain, prior to the report release date, the following documentation related to the work performed by other auditors (including auditors associated with other offices of the firm, affiliated firms, or non-affiliated firms):

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[3] Section 11 of the Securities Act of 1933 makes specific mention of the auditor's responsibility as an expert when the auditor's report is included in a registration statement under the 1933 Act.

[4] Section 106(b) of the Sarbanes-Oxley Act of 2002 imposes certain requirements concerning production of the work papers of a foreign public accounting firm on whose opinion or services the auditor relies. Compliance with this standard does not substitute for compliance with Section 106(b) or any other applicable law.

a. An engagement completion document consistent with paragraphs 12 and 13.

Note: This engagement completion document should include all cross-referenced, supporting audit documentation.

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

c. Sufficient information relating to any significant findings or issues that are inconsistent with or contradict the final conclusions, as described in paragraph 8.

d. Any findings affecting the consolidating or combining of accounts in the consolidated financial statements.

e. Sufficient information to enable the office issuing the auditor's report to agree or to reconcile the financial statement amounts audited by the other auditor to the information underlying the consolidated financial statements.

f. 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.

g. All significant deficiencies and material weaknesses in internal control over financial reporting, including a clear distinction between those two categories.

h. Letters of representations from management.

i. All matters to be communicated to the audit committee.

If the auditor decides to make reference in his or her report to the audit of the other auditor, however, the auditor issuing the report need not perform the procedures in this paragraph and, instead, should refer to AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

20. The auditor also might be required to maintain documentation in addition to that required by this standard.[5]

[21.] *[Paragraph 21. and preceding heading, "Effective Date," deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[5] For example, the SEC requires auditors to retain, in addition to documentation required by this standard, memoranda, correspondence, communications (for example, electronic mail), other documents, and records (in the form of paper, electronic, or other media) that are created, sent, or received in connection with an engagement conducted in accordance with auditing and related professional practice standards and that contain conclusions, opinions, analyses, or data related to the engagement. (*Retention of Audit and Review Records*, 17 CFR §210.2-06, effective for audits or reviews completed on or after October 31, 2003.)

Appendix A

Background and Basis for Conclusions

Introduction

A1. This appendix summarizes considerations that the Public Company Accounting Oversight Board ("PCAOB" or "Board") deemed significant in developing this standard. This Appendix includes reasons for accepting certain views and rejecting others.

A2. Section 103(a)(2)(A)(i) of the Sarbanes-Oxley Act of 2002 (the "Act") directs the Board to establish auditing standards that require registered public accounting firms to prepare and maintain, for at least seven years, audit documentation "in sufficient detail to support the conclusions reached" in the auditor's report. Accordingly, the Board has made audit documentation a priority.

Background

A3. Auditors support the conclusions in their reports with a work product called *audit documentation*, also referred to as *working papers* or *work papers*. Audit documentation supports the basis for the conclusions in the auditor's report. Audit documentation also facilitates the planning, performance, and supervision of the engagement and provides the basis for the review of the quality of the work by providing the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Examples of audit documentation include memoranda, confirmations, correspondence, schedules, audit programs, and letters of representation. Audit documentation may be in the form of paper, electronic files, or other media.

A4. The Board's standard on audit documentation is one of the fundamental building blocks on which both the integrity of audits and the Board's oversight will rest. The Board believes that the quality and integrity of an audit depends, in large part, on the existence of a complete and understandable record of the work the auditor performed, the conclusions the auditor reached, and the evidence the auditor obtained that supports those conclusions. Meaningful reviews, whether by the Board in the context of its inspections or through other reviews, such as internal quality control reviews, would be difficult or impossible without adequate documentation. Clear and comprehensive audit documentation is essential to enhance the quality of the audit and, at the same time, to allow the Board to fulfill its mandate to inspect registered public accounting firms to assess the degree of compliance of those firms with applicable standards and laws.

A5. The Board began a standards-development project on audit documentation by convening a public roundtable discussion on September 29, 2003, to discuss issues and hear views on the subject. Participants at the roundtable included representatives from public companies, public accounting firms, investor groups, and regulatory organizations.

A6. Prior to this roundtable discussion, the Board prepared and released a briefing paper on audit documentation that posed several questions to help identify the objectives—and the appropriate scope and form—of audit documentation. In addition, the Board asked participants to address specific issues in practice relating to, among other things, changes in audit documentation after release of the audit report, essential elements and the appropriate amount of detail of

audit documentation, the effect on audit documentation of a principal auditor's decision to use the work of other auditors, and retention of audit documentation. Based on comments made at the roundtable, advice from the Board's staff, and other input the Board received, the Board determined that the pre-existing standard on audit documentation, Statement on Auditing Standards ("SAS") No. 96, *Audit Documentation*, was insufficient for the Board to discharge appropriately its standard-setting obligations under Section 103(a) of the Act. In response, the Board developed and issued for comment, on November 17, 2003, a proposed auditing standard titled, *Audit Documentation*.

A7. The Board received 38 comment letters from a variety of interested parties, including auditors, regulators, professional associations, government agencies, and others. Those comments led to some changes in the requirements of the standard. Also, other changes made the requirements easier to understand. The following sections summarize significant views expressed in those comment letters and the Board's responses to those comments.

Objective of This Standard

A8. The objective of this standard is to improve audit quality and enhance public confidence in the quality of auditing. Good audit documentation improves the quality of the work performed in many ways, including, for example:

- Providing a record of actual work performed, which provides assurance that the auditor accomplishes the planned objectives.
- Facilitating the reviews performed by supervisors, managers, engagement partners, engagement quality reviewers,[1] and PCAOB inspectors.
- Improving effectiveness and efficiency by reducing time-consuming, and sometimes inaccurate, oral explanations of what was done (or not done).

A9. The documentation requirements in this standard should result in more effective and efficient oversight of registered public accounting firms and associated persons, thereby improving audit quality and enhancing investor confidence.

A10. Inadequate audit documentation diminishes audit quality on many levels. First, if audit documentation does not exist for a particular procedure or conclusion related to a significant matter, it casts doubt as to whether the necessary work was done. If the work was not documented, then it becomes difficult for the engagement team, and others, to know what was done, what conclusions were reached, and how those conclusions were reached. In addition, good audit documentation is very important in an environment in which engagement staff changes or rotates. Due to engagement staff turnover, knowledgeable staff on an engagement may not be available for the next engagement.

Audit Programs

A11. Several commenters suggested that audit documentation should include audit programs. Audit programs were specifically mentioned in SAS No. 96 as a form of audit documentation.

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[1] The engagement quality reviewer is referred to as the concurring partner reviewer in the membership requirements of the AICPA SEC Practice Section. The Board adopted certain of these membership requirements as they existed on April 16, 2003. Some firms also may refer to this designated reviewer as the second partner reviewer.

A12. The Board accepted this recommendation, and paragraph 4 in the final standard includes audit programs as an example of documentation. Audit programs may provide evidence of audit planning as well as limited evidence of the execution of audit procedures, but the Board believes that signed-off audit programs should generally not be used as the sole documentation that a procedure was performed, evidence was obtained, or a conclusion was reached. An audit program aids in the conduct and supervision of an engagement, but completed and initialed audit program steps should be supported with proper documentation in the working papers.

Reviewability Standard

A13. The proposed standard would have adapted a standard of reviewability from the U.S. General Accounting Office's ("GAO") documentation standard for government and other audits conducted in accordance with generally accepted government auditing standards ("GAGAS"). The GAO standard provides that "Audit documentation related to planning, conducting, and reporting on the audit should contain sufficient information to enable an experienced auditor who has had no previous connection with the audit to ascertain from the audit documentation the evidence that supports the auditors' significant judgments and conclusions."[2] This requirement has been important in the field of government auditing because government audits have long been reviewed by GAO auditors who, although experienced in auditing, do not participate in the actual audits. Moreover, the Panel on Audit Effectiveness recommended that sufficient, specific requirements for audit documentation be established to enable public accounting firms' internal inspection teams as well as others, including reviewers outside of the firms, to assess the quality of engagement performance.[3] Audits and reviews of issuers' financial statements will now, under the Act, be subject to review by PCAOB inspectors. Therefore, a documentation standard that enables an inspector to understand the work that was performed in an audit or review is appropriate.

A14. Accordingly, the Board's proposed standard would have required that audit documentation contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the work that was performed, the name of the person(s) who performed it, the date it was completed, and the conclusions reached. This experienced auditor also should have been able to determine who reviewed the work and the date of such review.

A15. Some commenters suggested that the final standard more specifically describe the qualifications of an experienced auditor. These commenters took the position that only an engagement partner with significant years of experience would have the experience necessary to be able to understand all the work that was performed and the conclusions that were reached. One commenter suggested that an auditor who is reviewing audit documentation should have experience and knowledge consistent with the experience and knowledge that the auditor performing the audit would be required to possess, including knowledge of the current accounting, auditing, and financial reporting issues of the company's industry. Another said that the characteristics defining an experienced auditor should be consistent with those expected of the auditor with final responsibility for the engagement.

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[2] U.S. General Accounting Office, *Government Auditing Standards*, "Field Work Standards for Financial Audits" (2003 Revision), paragraph 4.22.

[3] Panel on Audit Effectiveness, *Report and Recommendations* (Stamford, Ct: Public Oversight Board, August 31, 2000).

A16. After considering these comments, the Board has provided additional specificity about the meaning of the term, *experienced auditor*. The standard now describes an experienced auditor as one who has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry.

A17. Some commenters also suggested that the standard, as proposed, did not allow for the use of professional judgment. These commenters pointed to the omission of a statement about professional judgment found in paragraph 4.23 of GAGAS that states, "The quantity, type, and content of audit documentation are a matter of the auditors' professional judgment." A nearly identical statement was found in the interim auditing standard, SAS No. 96, *Audit Documentation*.

A18. Auditors exercise professional judgment in nearly every aspect of planning, performing, and reporting on an audit. Auditors also exercise professional judgment in the documentation of an audit and other engagements. An objective of this standard is to ensure that auditors give proper consideration to the need to document procedures performed, evidence obtained, and conclusions reached in light of time and cost considerations in completing an engagement.

A19. Nothing in the standard precludes auditors from exercising their professional judgment. Moreover, because professional judgment might relate to any aspect of an audit, the Board does not believe that an explicit reference to professional judgment is necessary every time the use of professional judgment may be appropriate.

Audit Documentation Must Demonstrate That the Work Was Done

A20. A guiding principle of the proposed standard was that auditors must document procedures performed, evidence obtained, and conclusions reached. This principle is not new and was found in the interim standard, SAS No. 96, *Audit Documentation*, which this standard supersedes. Audit documentation also should demonstrate compliance with the standards of the PCAOB and include justification for any departures.

A21. The proposed standard would have adapted a provision in the California Business and Professions Code which provides that if documentation does not exist, then there is a rebuttable presumption that the work had not been done.

A22. The objections to this proposal fell into two general categories: the effect of the rebuttable presumption on legal proceedings and the perceived impracticality of documenting every conversation or conclusion that affected the engagement. Discussion of these issues follows.

Rebuttable Presumption

A23. Commenters expressed concern about the effects of the proposed language on regulatory or legal proceedings outside the context of the PCAOB's oversight. They argued that the rebuttable presumption might be understood to establish evidentiary rules for use in judicial and administrative proceedings in other jurisdictions.

A24. Some commenters also had concerns that oral explanation alone would not constitute persuasive other evidence that work was done, absent any documentation. Those commenters argued that not allowing oral explanations when there was no documentation would essentially make the presumption "irrebuttable." Moreover, those commenters argued that it was inappropriate for a professional standard to predetermine for a court the relative value of evidence.

A25. The Board believes that complete audit documentation is necessary for a quality audit or other engagement. The Board intends the standard to require auditors to document procedures performed, evidence obtained, and conclusions reached to improve the quality of audits. The Board also intends that a deficiency in documentation is a departure from the Board's standards. Thus, although the Board removed the phrase *rebuttable presumption*, the Board continues to stress, in paragraph 9 of the standard, that the auditor must have persuasive other evidence that the procedures were performed, evidence was obtained, and appropriate conclusions were reached with respect to relevant financial statement assertions.

A26. The term *should* (presumptively mandatory responsibility) was changed to *must* (unconditional responsibility) in paragraph 6 to establish a higher threshold for the auditor. Auditors have an unconditional requirement to document their work. Failure to discharge an unconditional responsibility is a violation of the standard and Rule 3100, which requires all registered public accounting firms to adhere to the Board's auditing and related professional practice standards in connection with an audit or review of an issuer's financial statements.

A27. The Board also added two new paragraphs to the final standard to explain the importance and associated responsibility of performing the work and adequately documenting all work that was performed. Paragraph 7 provides a list of factors the auditor should consider in determining the nature and extent of documentation. These factors should be considered by both the auditor in preparing the documentation and the reviewer in evaluating the documentation.

A28. In paragraph 9 of this standard, if, after the documentation completion date, as a result of a lack of documentation or otherwise, it appears that audit procedures may not have been performed, evidence may not have been obtained, or appropriate conclusions may not have been reached, the auditor must determine, and if so demonstrate, that sufficient procedures were performed, sufficient evidence was obtained, and appropriate conclusions were reached with respect to the relevant financial statement assertions. In those circumstances, for example, during an inspection by the Board or during the firm's internal quality control review, the auditor is required to demonstrate with persuasive other evidence that the procedures were performed, the evidence was obtained, and appropriate conclusions were reached. In this and similar contexts, oral explanation alone does not constitute persuasive other evidence. However, oral evidence may be used to clarify other written evidence.

A29. In addition, more reliable, objective evidence may be required depending on the nature of the test and the objective the auditor is trying to achieve. For example, if there is a high risk of a material misstatement with respect to a particular assertion, then the auditor should obtain and document sufficient procedures for the auditor to conclude on the fairness of the assertion.

Impracticality

A30. Some commenters expressed concern that the proposed standard could be construed or interpreted to require the auditor to document every conversation held with company management or among the engagement team members. Some commenters also argued that they should not be required to document every conclusion, including preliminary conclusions that were part of a thought process that may have led them to a different conclusion, on the ground that this would result in needless and costly work performed by the auditor. Commenters also expressed concern that an unqualified requirement to document

procedures performed, evidence obtained, and conclusions reached without allowing the use of auditor judgment would increase the volume of documentation but not the quality. They stated that it would be unnecessary, time-consuming, and potentially counterproductive to require the auditor to make a written record of everything he or she did.

A31. The Board's standard distinguishes between (1) an audit procedure that must be documented and (2) a conversation with company management or among the members of the engagement team. Inquiries with management should be documented when an inquiry is important to a particular procedure. The inquiry could take place during planning, performance, or reporting. The auditor need not document each conversation that occurred.

A32. A final conclusion is an integral part of a working paper, unless the working paper is only for informational purposes, such as documentation of a discussion or a process. This standard does not require that the auditor document each interim conclusion reached in arriving at the risk assessments or final conclusions. Conclusions reached early on during an audit may be based on incomplete information or an incorrect understanding. Nevertheless, auditors should document a final conclusion for every audit procedure performed, if that conclusion is not readily apparent based on documented results of the procedures.

A33. The Board also believes the reference to *specialists* is an important element of paragraph 6. Specialists play a vital role in audit engagements. For example, appraisers, actuaries, and environmental consultants provide valuable data concerning asset values, calculation assumptions, and loss reserves. When using the work of a specialist, the auditor must ensure that the specialist's work, as it relates to the audit objectives, also is adequately documented. For example, if the auditor relies on the work of an appraiser in obtaining the fair value of commercial property available for sale, then the auditor must ensure the appraisal report is adequately documented. Moreover, the term *specialist* in this standard is intended to include any specialist the auditor relies on in conducting the work, including those employed or retained by the auditor or by the company.

Audit Adjustments

A34. Several commenters recommended that the definition of *audit adjustments* in this proposed standard should be consistent with the definition contained in AU sec. 380, *Communication With Audit Committees*.

A35. Although the Board recognizes potential benefits of having a uniform definition of the term *audit adjustments*, the Board does not believe that the definition in AU sec. 380 is appropriate for this documentation standard because that definition was intended for communication with audit committees. The Board believes that the definition should be broader so that the engagement partner, engagement quality reviewer, and others can be aware of all proposed corrections of misstatements, whether or not recorded by the entity, of which the auditor is aware, that were or should have been proposed based on the audit evidence.

A36. Adjustments that should have been proposed based on known audit evidence are material misstatements that the auditor identified but did not propose to management. Examples include situations in which (1) the auditor identifies a material error but does not propose an adjustment and (2) the auditor

proposes an adjustment in the working papers, but fails to note the adjustment in the summary or schedule of proposed adjustments.

Information That Is Inconsistent With or Contradicts the Auditor's Final Conclusions

A37. Paragraph .25 of AU sec. 326, *Evidential Matter*, states: "In developing his or her opinion, the auditor should consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements." Thus, during the conduct of an audit, the auditor should consider all relevant evidential matter even though it might contradict or be inconsistent with other conclusions. Audit documentation must contain information or data relating to significant findings or issues that are inconsistent with the auditor's final conclusions on the relevant matter.

A38. Also, information that initially appears to be inconsistent or contradictory, but is found to be incorrect or based on incomplete information, need not be included in the final audit documentation, provided that the apparent inconsistencies or contradictions were satisfactorily resolved by obtaining complete and correct information. In addition, with respect to differences in professional judgment, auditors need not include in audit documentation preliminary views based on incomplete information or data.

Retention of Audit Documentation

A39. The proposed standard would have required an auditor to retain audit documentation for seven years after completion of the engagement, which is the minimum period permitted under Section 103(a)(2)(A)(i) of the Act. In addition, the proposed standard would have added a new requirement that the audit documentation must be assembled for retention within a reasonable period of time after the auditor's report is released. Such reasonable period of time should not exceed 45 days.

A40. In general, those commenting on this documentation retention requirement did not have concerns with the time period of 45 days to assemble the working papers. However, some commenters suggested the Board tie this 45-day requirement to the filing date of the company's financial statements with the SEC. One commenter recommended that the standard refer to the same trigger date for initiating both the time period during which the auditor should complete work paper assembly and the beginning of the seven-year retention period.

A41. For consistency and practical implications, the Board agreed that the standard should have the same date for the auditor to start assembling the audit documentation and initiating the seven-year retention period. The Board decided that the seven-year retention period begins on the *report release date*, which is defined as the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements. In addition, auditors will have 45 days to assemble the complete and final set of audit documentation, beginning on the report release date. The Board believes that using the report release date is preferable to using the filing date of the company's financial statements, since the auditor has ultimate control over granting permission to use his or her report. If an auditor's report is not issued, then the audit documentation is to be retained for seven years from the date that fieldwork was substantially completed. If the auditor was unable to complete the engagement, then the seven-year period begins when the work on the engagement ceased.

Section 802 of Sarbanes-Oxley and the SEC's Implementing Rule

A42. Many commenters had concerns about the similarity in language between the proposed standard and the SEC final rule (issued in January 2003) on record retention, *Retention of Records Relevant to Audits and Reviews*.[4] Some commenters recommended that the PCAOB undertake a project to identify and resolve all differences between the proposed standard and the SEC's final rule. These commenters also suggested that the Board include similar language from the SEC final rule, Rule 2-06 of Regulation S-X, which limits the requirement to retain some items.

Differences Between Section 802 and This Standard

A43. The objective of the Board's standard is different from the objective of the SEC's rule on record retention. The objective of the Board's standard is to require auditors to create certain documentation to enhance the quality of audit documentation, thereby improving the quality of audits and other related engagements. The records retention section of this standard, mandated by Section 103 of the Act, requires registered public accounting firms to "prepare and maintain for a period of not less than 7 years, *audit work papers, and other information related to any audit report*, in sufficient detail to support the conclusions reached in such report." (emphasis added)

A44. In contrast, the focus of the SEC rule is to require auditors to *retain* documents that the auditor does create, in order that those documents will be available in the event of a regulatory investigation or other proceeding. As stated in the release accompanying the SEC's final rule (SEC Release No. 33-8180):

> Section 802 of the Sarbanes-Oxley Act is intended to address the destruction or fabrication of evidence and the preservation of "financial and audit records." We are directed under that section to promulgate rules related to the retention of records relevant to the audits and reviews of financial statements that companies file with the Commission.

A45. The SEC release further states, "New rule 2-06 . . . addresses the retention of documents relevant to enforcement of the securities laws, Commission rules, and criminal laws."

A46. Despite their different objectives, the proposed standard and SEC Rule 2-06 use similar language in describing documentation generated during an audit or review. Paragraph 4 of the proposed standard stated that, "Audit documentation ordinarily consists of *memoranda, correspondence*, schedules, and *other documents created* or obtained *in connection with* the engagement and may be in the form of paper, electronic files, or other media." Paragraph (a) of SEC Rule 2-06 describes "records relevant to the audit or review" that must be retained as, (1) "workpapers and other documents that form the basis of the audit or review and (2) *memoranda, correspondence*, communications, *other documents*, and records (including electronic records), which: [a]re *created*, sent or received *in connection with* the audit or review and [c]ontain conclusions, opinions, analyses, or financial data related to the audit or review. . . ." (numbering and emphasis added).

A47. The SEC makes a distinction between the objectives of categories (1) and (2). Category (1) includes audit documentation. Documentation to be retained

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[4] SEC Regulation S-X, 17 C.F.R. § 210.2-06 (SEC Release No. 33-8180, January 2003). (The final rule was effective in March 2003.)

according to the Board's standard clearly falls within category (1). Items in category (2) include "desk files" which are more than "what traditionally has been thought of as auditor's 'workpapers'." The SEC's rule requiring auditors to retain items in category (2) have the principal purpose of facilitating enforcement of securities laws, SEC rules, and criminal laws. This is not an objective of the Board's standard. According to SEC Rule 2-06, items in category (2) are limited to those which: (*a*) are created, sent or received in connection with the audit or review, and (*b*) contain conclusions, opinions, analyses, or financial data related to the audit or review. The limitations, (*a*) and (*b*), do not apply to category (1).

A48. Paragraph 4 of the final standard deletes the reference in the proposed standard to "other documents created or obtained in connection with the engagement." The Board decided to keep "correspondence" in the standard because correspondence can be valid audit evidence. Paragraph 20 of the standard reminds the auditor that he or she may be required to maintain documentation in addition to that required by this standard.

Significant Matters and Significant Findings or Issues

A49. Some commenters asked how the term *significant matters*, in Rule 2-06, relates to the term *significant findings or issues* in the Board's standard. The SEC's release accompanying its final Rule 2-06 states that ". . . *significant matters* is intended to refer to the documentation of substantive matters that are important to the audit or review process or to the financial statements of the issuer. . . ." This is very similar to the term *significant findings or issues* contained in paragraph 12 of the Board's standard which requires auditors to document *significant findings or issues*, actions taken to address them (including additional evidence obtained), and the basis for the conclusions reached. Examples of significant findings or issues are provided in the standard.

A50. Based on the explanation in the SEC's final rule and accompanying release, the Board believes that *significant matters* are included in the meaning of *significant findings or issues* in the Board's standard. The Board is of the view that *significant findings or issues* is more comprehensive and provides more clarity than *significant matters* and, therefore, has not changed the wording in the final standard.

Changes to Audit Documentation

A51. The proposed standard would have required that any changes to the working papers after completion of the engagement be documented without deleting or discarding the original documents. Such documentation must indicate the date the information was added, by whom it was added, and the reason for adding it.

A52. One commenter recommended that the Board provide examples of auditing procedures that should be performed before the report release date and procedures that may be performed after the report release date. Some commenters also requested clarification about the treatment of changes to documentation that occurred after the completion of the engagement but before the report release date. Many commenters recommended that the Board more specifically describe post-issuance procedures. The Board generally agreed with these comments.

A53. The final standard includes two important dates for the preparation of audit documentation: (1) the report release date and (2) the documentation completion date.

- Prior to the report release date, the auditor must have completed all necessary auditing procedures, including clearing review notes and providing support for all final conclusions. In addition, the auditor must have obtained sufficient evidence to support the representations in the auditor's reports before the report release date.
- After the report release date and prior to the documentation completion date, the auditor has 45 calendar days in which to assemble the documentation.

A54. During the audit, audit documentation may be superseded for various reasons. Often, during the review process, reviewers annotate the documentation with clarifications, questions, and edits. The completion process often involves revising the documentation electronically and generating a new copy. The SEC's final rule on record retention, *Retention of Records Relevant to Audits and Reviews*,[5] explains that the SEC rule does not require that the following documents generally need to be retained: superseded drafts of memoranda, financial statements or regulatory filings; notes on superseded drafts of memoranda, financial statements or regulatory filings that reflect incomplete or preliminary thinking; previous copies of workpapers that have been corrected for typographical errors or errors due to training of new employees; and duplicates of documents. This standard also does not require auditors to retain such documents as a general matter.

A55. Any documents, however, that reflect information that is either inconsistent with or contradictory to the conclusions contained in the final working papers may not be discarded. Any documents added must indicate the date they were added, the name of the person who prepared them, and the reason for adding them.

A56. If the auditor obtains and documents evidence after the report release date, the auditor should refer to the Interim Auditing Standards, AU sec. 390, *Consideration of Omitted Procedures After the Report Date* and AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. Auditors should not discard any previously existing documentation in connection with obtaining and documenting evidence after the report release date.

A57. The auditor may perform certain procedures subsequent to the report release date. For example, pursuant to AU sec. 711, *Filings Under Federal Securities Statutes*, auditors are required to perform certain procedures up to the effective date of a registration statement. The auditor should identify and document any additions to audit documentation as a result of these procedures. No audit documentation should be discarded after the documentation completion date, even if it is superseded in connection with any procedures performed, including those performed pursuant to AU sec. 711.

A58. Additions to the working papers may take the form of memoranda that explain the work performed, evidence obtained, and conclusions reached. Documentation added to the working papers must indicate the date the information was added, the name of the person adding it, and the reason for adding it. All previous working papers must remain intact and not be discarded.

A59. Documentation added to the working papers well after completion of the audit or other engagement is likely to be of a lesser quality than that produced contemporaneously when the procedures were performed. It is very difficult to reconstruct activities months, and perhaps years, after the work was actually performed. The turnover of both firm and company staff can cause difficulty in reconstructing conversations, meetings, data, or other evidence. Also, with

[5] See footnote 4.

the passage of time memories fade. Oral explanation can help confirm that procedures were performed during an audit, but oral explanation alone does not constitute persuasive other evidence. The primary source of evidence should be documented at the time the procedures are performed, and oral explanation should not be the primary source of evidence. Furthermore, any oral explanation should not contradict the documented evidence, and appropriate consideration should be given to the credibility of the individual providing the oral explanation.

Multi-Location Audits and Using the Work of Other Auditors

A60. The proposed standard would have required the principal auditor to maintain specific audit documentation when he or she decided not to make reference to the work of another auditor.

A61. The Board also proposed an amendment to AU sec. 543 concurrently with the proposed audit documentation standard. The proposed amendment would have required the principal auditor to review the documentation of the other auditor to the same extent and in the same manner that the audit work of all those who participated in the engagement is reviewed.

A62. Commenters expressed concerns that these proposals could present conflicts with certain non-U.S. laws. Those commenters also expressed concern about the costs associated with the requirement for the other auditor to ship their audit documentation to the principal auditor. In addition, the commenters also objected to the requirement that principal auditors review the work of other auditors as if they were the principal auditor's staff.

Audit Documentation Must Be Accessible to the Office Issuing the Auditor's Report

A63. After considering these comments, the Board decided that it could achieve one of the objectives of the proposed standard (that is, to require that the issuing office have access to those working papers on which it placed reliance) without requiring that the working papers be shipped to the issuing office. Further, given the potential difficulties of shipping audit documentation from various non-U.S. locations, the Board decided to modify the proposed standard to require that audit documentation either be retained by or be accessible to the issuing office.

A64. In addition, instead of requiring that all of the working papers be shipped to the issuing office, the Board decided to require that the issuing office obtain, review, and retain certain summary documentation. Thus, the public accounting firm issuing an audit report on consolidated financial statements of a multinational company may not release that report without the documentation described in paragraph 19 of the standard.

A65. The auditor must obtain and review and retain, prior to the report release date, documentation described in paragraph 19 of the standard, in connection with work performed by other offices of the public accounting firm or other auditors, including affiliated or non-affiliated firms, that participated in the audit. For example, an auditor that uses the work of another of its offices or other affiliated or non-affiliated public accounting firms to audit a subsidiary that is material to a company's consolidated financial statements must obtain the documentation described in paragraph 19 of the standard, prior to the report release date. On the other hand, an auditor that uses the work of another of its offices or other affiliated or non-affiliated firms, to perform selected procedures, such as observing the physical inventories of a company, may not be required to obtain the documentation specified in paragraph 19 of the standard. However,

this does not reduce the need for the auditor to obtain equivalent documentation prepared by the other auditor when those instances described in paragraph 19 of the standard are applicable.

Amendment to AU Sec. 543, *Part of Audit Performed by Other Independent Auditors*

A66. Some commenters also objected to the proposed requirement in the amendment to AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, that the principal auditor review another auditor's audit documentation. They objected because they were of the opinion such a review would impose an unnecessary cost and burden given that the other auditor will have already reviewed the documentation in accordance with the standards established by the principal auditor. The commenters also indicated that any review by the principal auditor would add excessive time to the SEC reporting process, causing even more difficulties as the SEC Form 10-K reporting deadlines have become shorter recently and will continue to shorten next year.

A67. The Board accepted the recommendation to modify the proposed amendment to AU sec. 543, *Part of Audit Performed by Other Independent Auditors*. Thus, in the final amendment, the Board imposes the same unconditional responsibility on the principal auditor to obtain certain audit documentation from the other auditor prior to the report release date. The final amendment also provides that the principal auditor should consider performing one or more of the following procedures:

- Visit the other auditors and discuss the audit procedures followed and results thereof.
- Review the audit programs of the other auditors. In some cases, it may be appropriate to issue instructions to the other auditors as to the scope of the audit work.
- Review additional audit documentation of the other auditors relating to significant findings or issues in the engagement completion document.

Effective Date

A68. The Board proposed that the standard and related amendment would be effective for engagements completed on or after June 15, 2004. Many commenters were concerned that the effective date was too early. They pointed out that some audits, already begun as of the proposed effective date, would be affected and that it could be difficult to retroactively apply the standard. Some commenters also recommended delaying the effective date to give auditors adequate time to develop and implement processes and provide training with respect to several aspects of the standard.

A69. After considering the comments, the Board has delayed the effective date. However, the Board also believes that a delay beyond 2004 is not in the public interest.

A70. The Board concluded that the implementation date of this standard should coincide with that of PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, because of the documentation issues prevalent in PCAOB Auditing Standard No. 2. Therefore, the Board has decided that the standard will be effective for audits of financial statements with respect to fiscal years ending on or after November 15, 2004. The effective date for reviews of interim

financial information and other engagements, conducted pursuant to the standards of the PCAOB, would occur beginning with the first quarter ending after the first financial statement audit covered by this standard.

Reference to Audit Documentation As the Property of the Auditor

A71. Several commenters noted that SAS No. 96, *Audit Documentation*, the interim auditing standard on audit documentation, referred to audit documentation as the property of the auditor. This was not included in the proposed standard because the Board did not believe ascribing property rights would have furthered this standard's purpose to enhance the quality of audit documentation.

Confidential Client Information

A72. SAS No. 96, *Audit Documentation*, also stated that, "the auditor has an ethical, and in some situations a legal, obligation to maintain the confidentiality of client information," and referenced Rule 301, *Confidential Client Information*, of the AICPA's Code of Professional Conduct. Again, the Board's proposed standard on audit documentation did not include this provision. In adopting certain interim standards and rules as of April 16, 2003, the Board did not adopt Rule 301 of the AICPA's Code of Professional Conduct. In this standard on audit documentation, the Board seeks neither to establish confidentiality standards nor to modify or detract from any existing applicable confidentiality requirements.

Attachment

PCAOB Release No. 2004-006

June 9, 2003
PCAOB Rulemaking
Docket Matter No. 012

Summary

After public comment, the Public Company Accounting Oversight Board (the "PCAOB" or "Board") has adopted Auditing Standard No. 3, *Audit Documentation*, and an amendment to AU sec. 543 of the Interim Auditing Standards. The Board will submit this standard and amendment to the Securities and Exchange Commission ("SEC" or "Commission") for approval pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 (the "Act"). This standard will not take effect unless approved by the Commission.

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Section 103(a)(2)(A)(i) of the Act expressly directs the Board to establish auditing standards that require registered public accounting firms to prepare and maintain, for at least seven years, audit documentation "in sufficient detail to support the conclusions reached" in the auditor's report. Audit documentation is one of only a few topics that the Act expressly requires the Board to adopt standards. Accordingly, the Board made audit documentation a priority in its standards setting responsibilities.

The Board commenced a standards-development project on audit documentation by convening a public roundtable discussion on September 29, 2003, to discuss issues and hear views on audit documentation. Before that roundtable discussion, the Board prepared and released a briefing paper on audit documentation, which posed several questions to help identify the objectives—and the appropriate scope and form—of audit documentation.[1] In addition, the Board asked participants to address specific practice issues relating to, among other things, changes in audit documentation after an audit report has been released; the essential elements and the appropriate amount of detail of audit documentation; the effect on audit documentation of a principal auditor's decision to use the work of other auditors; and retention of audit documentation.

Taking into consideration comments from participants in this roundtable discussion, advice from the Board's staff, and other input, the Board determined that the existing interim auditing standard on audit documentation was not sufficient in providing direction to ensure that auditors appropriately document both the work they perform and the conclusions they reach in connection with audits and other engagements. On November 21, 2003, the Board issued a proposed auditing standard entitled *Audit Documentation*, as well as a related

[1] See Briefing Paper for the Roundtable on Audit Documentation, dated September 10, 2003. The transcript of the September 29, 2003 roundtable discussion and copies of the briefing paper are available on the Board's Web site (www.pcaobus.org).

amendment to an interim auditing standard (paragraph .12 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*).

The Board received 38 comment letters from a variety of interested parties, including auditors, regulators, professional associations, and government agencies. Those comments led to some changes in the requirements of the standard.

The Board's standard on audit documentation will be one of the fundamental building blocks on which both the integrity of audits and the Board's oversight will rest. The integrity of an audit depends, in large part, on the existence of a complete and understandable record of the work that the auditor performed, the evidence gathered, and the conclusions reached. Meaningful review by managers and partners, or by the Board in the context of its inspections, would be difficult, if not impossible, without adequate documentation. Clear and comprehensive audit documentation is essential for auditors to enhance the quality of the audit and for the Board to fulfill its mandate to inspect registered public accounting firms "to assess the degree of compliance" of those firms with applicable standards and laws.

Appendices 1 and 2 to this release contain, respectively, the text of Auditing Standard No. 3, *Audit Documentation*, and the amendment to AU sec. 543. Appendix A to Auditing Standard No. 3 includes the Board's analysis of the comments received and the Board's responses.

A. Introduction

Auditors document the evidence supporting the conclusions reached in their reports with a work product commonly referred to as *audit documentation* or *working papers*. Sufficient audit documentation is an integral part of a quality audit. That is, the auditor documents not only the nature, timing, and extent of the work performed, but also the professional judgments made by members of the engagement team and others.

In addition to providing the basis for the conclusions in the auditor's report, audit documentation facilitates the planning, performance, and supervision of the engagement and provides the basis for the review of the quality of the work by providing the reviewer with written documentation of the evidence supporting the auditor's significant conclusions.

First and foremost, the objectives of this audit documentation standard are to improve audit quality and to enhance public confidence in the quality of auditing and other engagements. Complete and thorough audit documentation improves the quality of the work performed in many ways. One important example is that quality audit documentation is a record of the actual work performed, which provides assurance that the auditor accomplished the planned objectives. Further, the need to document the procedures performed, the evidence obtained, and the conclusions reached demands a disciplined approach to planning and performing the engagement. Also, audit documentation facilitates the reviews performed by supervisors, managers, partners, and PCAOB inspectors.

Inadequate audit documentation diminishes audit quality on many levels. First, if audit documentation does not exist for a particular procedure or conclusion related to a significant matter, its absence casts doubt as to whether the necessary work was done. If the work was not documented, then it becomes difficult for members of the engagement team, and others, to know what was done, what conclusions were reached, and how those conclusions were reached.

The more significant differences between existing requirements under the interim auditing standards and this new standard on audit documentation, along with the related amendment, are described in the following sections.

B. Auditors Must Document Their Work

As previously mentioned, the principal objective of this standard is to improve the quality of audits and other engagements. In so doing, this standard affirmatively requires that auditors document procedures performed, evidence obtained, and conclusions reached. Likewise, a deficiency in documentation is a departure from the Board's standard. The Board emphasizes that, in the event of a deficiency in documentation, the auditor must be prepared to present persuasive other evidence that the procedures were performed, evidence was obtained, and appropriate conclusions were reached.

If it is questionable whether audit procedures were performed or evidence was obtained, the auditor must determine, and if so demonstrate, that the necessary procedures were performed, sufficient evidence was obtained, and appropriate conclusions were reached with respect to the relevant financial statement assertions. There may be circumstances (for example, a Board inspection) in which the auditor may be required to demonstrate with persuasive other evidence that the procedures were actually performed, the evidence was actually obtained, and appropriate conclusions were actually reached. In this and similar contexts, oral explanation alone does not constitute persuasive other evidence. However, oral evidence may be used to clarify other written evidence.

The failure to prepare adequate documentation is serious. The severity of that failure depends on the factors that determine the nature and extent of the documentation for a particular audit area or auditing procedure. For example, when the risk of material misstatement associated with an assertion is high, the failure to document the procedures, evidence, and conclusions related to that assertion is a very serious violation of PCAOB Standards. Failure to provide adequate documentation could limit an auditor's ability to demonstrate that the work was actually performed.

C. An Experienced Auditor Must Understand the Work

Audits and reviews of issuers' financial statements are now, under the Act, subject to review by PCAOB inspectors. Therefore, the Board determined that a documentation standard that enables a PCAOB inspector to understand the work that was performed is essential. Similar to the U.S. General Accounting Office's documentation standard for government and other audits conducted in accordance with generally accepted government auditing standards,[2] this standard requires audit documentation to contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the work that was performed, the name of the person(s) who performed it, the date it was completed, and the conclusions reached.

This standard also defines an *experienced auditor* as one who has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry.

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[2] U.S. General Accounting Office, *Government Auditing Standards*, "Field Work Standards for Financial Audits" (2003 Revision), paragraph 4.22.

D. Two Significant Dates Defined in This Standard

To ensure quality and consistency in the preparation and retention of audit documentation, the standard defines two important dates: (1) the report release date and (2) the documentation completion date. The *report release date* is the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements. After the report release date, auditors will have 45 days to assemble a complete and final set of audit documentation. The end of this 45-day period is the *documentation completion date*.

Prior to the report release date, the auditor must have—

- Completed all necessary auditing procedures, including clearing review notes and providing support for all final conclusions, and
- Obtained sufficient evidence to support the representations in the auditor's report.

If the auditor obtains and documents evidence after the report release date, the auditor should refer to the interim auditing standards, AU sec. 390, *Consideration of Omitted Procedures After the Report Date* and AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* for related guidance. Auditors should not discard any previously existing documentation in connection with obtaining and documenting evidence after the report release date.

If procedures are performed subsequent to the report release date, auditors must identify and document any additions to audit documentation as a result of those procedures. This documentation must include the nature of the change, the date of the change, the name of the person who prepared the change, and the reason for the change. Furthermore, audit documentation must not be deleted or discarded after the documentation completion date.

E. Subsequent Changes to Audit Documentation

This standard requires that changes to audit documentation after the documentation completion date be documented without deleting or discarding the original documents. Such documentation must indicate the date the information was added, who added it, and the reason for adding it. The SEC has articulated its position on working papers, as well as the importance of documenting any subsequent changes to the working papers.

> Working papers prepared or collected by auditors in the course of an audit provide the single most important support for their representation regarding compliance with generally accepted auditing standards. They serve as the repository for the competent evidential matter necessary to afford the auditors with a reasonable basis for opining on an issuer's financial position. Transactions or events occurring long after the balance sheet date often require reference to prior working papers, and such working papers may have significant usefulness in future audits. It is therefore imperative that auditors preserve their working papers in a complete and unaltered form.
>
> Auditors should be encouraged to devise orderly procedures for the proper control over the contents of working papers. Moreover, the Commission recognizes that the necessity for evidential matter to be included in the auditor's working papers varies substantially depending on individual audits. When any alterations or additions are made to the working papers subsequent to the issuance

of the auditor's report, however, such alterations or additions should themselves be properly documented and indicate the time and circumstances under which they are made.[3]

F. Documentation Deficiencies

Documentation added to the working papers well after completion of the audit or other engagement is likely to be of a lesser quality than that produced contemporaneously when the procedures were performed. It is very difficult to reconstruct and recall specific activities related to gathering audit evidence months, and perhaps years, after the work was actually performed. The turnover of both firm and company staff can cause difficulty in reconstructing conversations, meetings, data, or other evidence. Also, with the passage of time memories fade. "Research has shown that minutes, hours or days after an experience, memory preserves a relatively detailed record, allowing us to reproduce the past with reasonable if not perfect accuracy. But with the passing of time, the particulars fade and opportunities multiply for interference—generated by later, similar experiences—to blur our recollections."[4]

The Board believes that audit evidence should be documented at the time the procedures are performed and that oral explanation should not be the primary source of evidence. Furthermore, any oral explanation should not contradict the documented evidence, and appropriate consideration should be given to the credibility of the individual providing the oral explanation.

G. Multi-Location Audits

In this standard, the Board reminds auditors that the office of the accounting firm issuing the auditor's report is responsible for ensuring that all audit documentation sufficient to meet the requirements of this standard is prepared and retained. Audit documentation supporting the work performed by other auditors (including auditors associated with other offices of the firm, affiliated firms, or non-affiliated firms), must be retained by or be accessible to the office issuing the auditor's report. The Board believes this requirement will improve audit quality by enhancing the probability that *all* audit documentation will be prepared consistently with the same standards of audit quality.

In addition, the office issuing the auditor's report must obtain and review, prior to the report release date, certain documentation—outlined in this standard—related to the work performed by other auditors. Thus, the firm issuing an audit report on consolidated financial statements of a multinational company may not release that report without the specific documentation described in this standard.

H. Part of Audit Performed by Others

In reporting on a company's consolidated financial statements, an auditor may use the work of other auditors who have audited one or more affiliates or divisions of the company. When more than one auditor is involved in an audit

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[3] In the Matter of S.D. Leidesdorf & Co., Kenneth Larsen, Joseph Grendi (*Accounting Series Release No. 209, February 1977*).

[4] Dr. Daniel Schacter, "The Seven Sins of Memory: How the Mind Forgets and Remembers," *Psychology Today* (May 2001).

engagement, one of the firms typically serves as the principal auditor. The principal auditor then must decide whether to make reference in the auditor's report to the audit performed by the other auditor.

If the principal auditor decides to assume responsibility for the work of other auditors, then the principal auditor will not make reference to the work of other auditors in the audit report. However, if the principal auditor decides not to assume that responsibility, then the principal auditor should indicate clearly the division of responsibility between the principal auditor and other auditors in expressing an opinion on the consolidated financial statements. Existing guidance in AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, applies when using the work of other auditors. However, this existing guidance does not establish any specific documentation requirements.

In connection with PCAOB Auditing Standard No. 3, *Audit Documentation*, the Board adopted an amendment to paragraph .12 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, addressing appropriate audit documentation when a principal auditor decides not to make reference to the work of other auditors. In this amendment, the Board imposes the same unconditional responsibility on the principal auditor, as with multi-location audits, to obtain certain audit documentation from the other auditor prior to the report release date. In addition, the amendment provides that the principal auditor should consider performing one or more of the procedures described in the amendment, such as discussing the audit procedures and related results with the other auditors and reviewing the audit programs of the other auditors.

The Board believes this amendment will enable the principal auditor to gain considerably more assurance about the quality of the other auditor's work without creating an unreasonable burden.

I. Retention of Audit Documentation

This standard requires that an auditor retain audit documentation for seven years after the report release date, which is the minimum period permitted under Section 103(a) of the Act.

As previously discussed, auditors will have 45 days after the report release date to assemble the complete and final set of audit documentation. If an auditor's report is not issued on a completed engagement, as is common in a review of interim financial information of a public company, then the audit documentation is to be retained for seven years from the date that fieldwork was substantially completed.

J. Effective Date

On March 9, 2004, the Board issued PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. Since documentation issues are prevalent in PCAOB Auditing Standard No. 2 and the key objective of this standard is to improve the quality of audits and other engagements, the Board determined that the implementation date of this standard should coincide with that of PCAOB Auditing Standard No. 2. Therefore, this standard will be effective for audits of financial statements with respect to fiscal years ending on or after the later of November 15, 2004, or 30 days after the date of approval of this standard by the SEC.

The effective date for quarterly reviews and other engagements, conducted pursuant to the standards of the PCAOB, would occur beginning with the first

quarter ending after the first financial statement audit covered by this standard.

* * * * * *

On the 9th day of June, in the year 2004, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Acting Secretary
June 9, 2004

APPENDICES—

1. Auditing Standard No. 3—*Audit Documentation*
2. Amendment to Interim Auditing Standards—*Part of Audit Performed by Other Independent Auditors*

Auditing Standard No. 3—Appendix 1

Audit Documentation

[Appendix omitted; see Auditing Standard No. 3 for the full text of the standard.]

Appendix 2

Amendment to Interim Auditing Standards—Part of Audit Performed by Other Independent Auditors

[Appendix omitted; see appendix 2 in PCAOB Release No. 2004-006 for a list of the amendments.]

Auditing Standard No. 4

Reporting on Whether a Previously Reported Material Weakness Continues to Exist

Source: Auditing Standard Nos. 8–15.

[Effective pursuant to SEC Release No. 34-53227; File No. PCAOB-2005-01, February 6, 2006; effective as of February 6, 2006.]

Applicability of Standard

1. This standard establishes requirements and provides direction that apply when an auditor is engaged to report on whether a previously reported material weakness in internal control over financial reporting (hereinafter referred to as a material weakness) continues to exist as of a date specified by management.

[The following note is effective November 15, 2007. See PCAOB Release 2007-005.]

> Note 1: In this context, previously reported material weakness means a material weakness that was described previously in an auditor's report issued pursuant to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.
>
> Note 2: The date specified by management as the date that the previously reported material weakness no longer exists must be a date after the date of management's most recent annual assessment.

2. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

An auditor may conduct an engagement to report on whether a previously reported material weakness continues to exist if (1) the auditor has audited the company's financial statements and internal control over financial reporting in accordance with Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, as of the date of the company's most recent annual assessment of internal control over financial reporting, or (2) the auditor has been engaged to perform an audit of the financial statements and internal control over financial reporting in accordance with Auditing Standard No. 5 in the current year and has a sufficient basis for performing this engagement. (See paragraph 26 of this standard for additional requirements that apply specifically to a successor auditor's application of this standard.)

[The following note is effective November 15, 2007. See PCAOB Release 2007-005.]

> Note: References in this standard to the company's most recent annual assessment of internal control over financial reporting apply to the company's most recent assessment of internal control over financial reporting overall, either as of the company's year-end or as of a more recent interim date, as audited by the auditor in accordance with Auditing Standard No. 5.

3. The auditor may report on more than one previously reported material weakness as part of a single engagement.

4. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

The engagement described by this standard is voluntary. The standards of the PCAOB do not require an auditor to undertake an engagement to report on whether a previously reported material weakness continues to exist. The auditor may audit the company's internal control over financial reporting in accordance with Auditing Standard No. 5 without ever performing an engagement in accordance with this standard.

Auditor's Objective in an Engagement to Report on Whether a Previously Reported Material Weakness Continues to Exist

5. The auditor's objective in an engagement to report on whether a previously reported material weakness continues to exist is to obtain reasonable assurance about whether the previously reported material weakness exists as of a date specified by management and to express an opinion thereon. The auditor's opinion relates to the existence of a specifically identified material weakness as of a specified date and does not relate to the effectiveness of the company's internal control over financial reporting overall.

6. To obtain reasonable assurance, the auditor should obtain and evaluate evidence about whether specified controls were designed and operated effectively as of the date specified by management and whether those controls satisfy the company's stated control objective.

> Note: Obtaining and evaluating evidence about whether the specified controls are designed effectively without also obtaining evidence about whether those controls operated effectively would not result in the auditor obtaining reasonable assurance for the purpose of expressing an opinion on whether a material weakness continues to exist.

Conditions for Engagement Performance

7. The auditor may report on whether a previously reported material weakness continues to exist at a company only if all of the following conditions are met:

a. Management accepts responsibility for the effectiveness of internal control over financial reporting;

b. Management evaluates the effectiveness of the specific control(s) that it believes addresses the material weakness using the same control criteria that management used for its most recent annual assessment of internal control over financial reporting and management's stated control objective(s);

c. Management asserts that the specific control(s) identified is effective in achieving the stated control objective;

d. Management supports its assertion with sufficient evidence, including documentation; and

e. Management presents a written report that will accompany the auditor's report that contains all the elements described in paragraph 48 of this standard.

8. If all the conditions in paragraph 7 of this standard are not met, the auditor is not permitted to complete the engagement to report on whether a previously reported material weakness continues to exist.

Framework and Definitions for Evaluation

9. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

The terms *internal control over financial reporting*, *deficiency*, *significant deficiency*, and *material weakness* have the same meanings as the definitions of those terms in Appendix A, *Definitions*, of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

10. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

Paragraph 5 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, states "[t]he 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." For purposes of an engagement to report on whether a previously reported material weakness continues to exist, both management and the auditor must use both (1) the same control criteria used for the company's most recent annual assessment of internal control over financial reporting, and (2) the company's stated control objective(s) to evaluate whether a material weakness continues to exist.

[The following note is effective November 15, 2007. See PCAOB Release 2007-005.]

> Note: The performance and reporting requirements in Auditing Standard No. 5 and in this standard are based on the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission's publication, *Internal Control—Integrated Framework*. Known as the COSO report, it provides a suitable and available framework for purposes of management's annual assessment of internal control over financial reporting. (More information about the COSO framework is included within the COSO report.)

11. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

The terms *relevant assertion* and *control objective* have the same meaning as the definitions of those terms in Appendix A, *Definitions*, of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.[1]

12. Management establishes control objectives that are tailored to the individual company. The process of tailoring control objectives to the individual company allows the control criteria used for management's annual assessment to be applied to the facts and circumstances in a reasonable and appropriate manner. Although control objectives are used most frequently to evaluate the effectiveness of control activities, the other components of internal control over financial reporting (i.e., control environment, risk assessment, information and communication, and monitoring) also can be expressed in terms of control objectives.

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[1] [This footnote is effective November 15, 2007. See PCAOB Release 2007-005.]

13. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

In an audit of internal control over financial reporting, the auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.[2]

14. Table 1 includes examples of control objectives and their related assertions:

Table 1—Examples of Control Objectives and Related Assertions

Control Objectives	Assertions
Recorded sales of product X initiated on the company's Web site are real	Existence or occurrence
Product X warranty losses that are probable and can be reasonably estimated are recorded as of the company's quarterly financial statement period-ends	Completeness
Interest rate swaps are recorded at fair value	Valuation or allocation
The company has legal title to recorded product X inventory in the company's Dallas, TX warehouse	Rights and obligations
Pending litigation that is reasonably possible to result in a material loss is disclosed in the quarterly and annual financial statements	Presentation and disclosure

15. If a material weakness has previously been reported, a necessary control objective (or objectives) has not been achieved.

16. A *stated control objective* in the context of an engagement to report on whether a material weakness continues to exist is the specific control objective identified by management that, if achieved, would result in the material weakness no longer existing.

17. Because the stated control objective, for purposes of this engagement, provides management and the auditor with a specific target against which to evaluate whether the material weakness continues to exist, management and the auditor must be satisfied that, if the stated control objective were achieved, the material weakness would no longer exist.

[The following note is effective November 15, 2007. See PCAOB Release 2007-005.]

> Note: When a material weakness has a pervasive effect on the company's internal control over financial reporting, identifying the related control objectives that are not being achieved may be difficult because of the large number of

[2] *[The following footnote is effective November 15, 2007. See PCAOB Release 2007-005.]* See paragraph 42 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

control objectives affected. A material weakness related to an ineffective control environment would be an example of this circumstance. If management and the auditor have difficulty identifying *all* of the stated control objectives affected by a material weakness, the material weakness probably is not suitable for this engagement and should be addressed, instead, through the auditor's annual audit of internal control over financial reporting conducted under Auditing Standard No. 5.

Performing an Engagement to Report on Whether a Previously Reported Material Weakness Continues to Exist

18. *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

In an engagement to report on whether a previously reported material weakness continues to exist, the auditor must obtain sufficient appropriate evidence about the design and operating effectiveness of specified controls that provide reasonable assurance that the company's stated control objective is achieved in the context of the control criteria (e.g., COSO).

Note 1: An individual material weakness may be associated with a single stated control objective or with more than one stated control objective, depending on the nature of the material weakness and the manner in which the company tailors its stated control objectives to its business.

[The following note is effective November 15, 2007. See PCAOB Release 2007-005.]

Note 2: Depending on the nature of the company's business, its organization, its internal control over financial reporting, and the specific material weakness that is the subject of this engagement, the auditor may determine that he or she is not able to obtain a sufficient basis for reporting on whether a previously reported material weakness continues to exist without performing a complete audit of internal control over financial reporting in accordance with Auditing Standard No. 5.

Applying the Standards of the PCAOB

19. The auditor must adhere to the standards of the PCAOB in performing an engagement to report on whether a previously reported material weakness continues to exist. Adherence to the standards involves:

a. Planning the engagement,

b. Obtaining an understanding of internal control over financial reporting,

c. Testing and evaluating whether a material weakness continues to exist, including using the work of others, and

d. Forming an opinion on whether a previously reported material weakness continues to exist.

20. Even though some requirements of this standard are set forth in a manner that suggests a sequential process, auditing whether a previously reported material weakness continues to exist involves a process of gathering, updating, and analyzing information. Accordingly, the auditor may perform some of the procedures and evaluations described in this section of the standard concurrently.

21. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

The engagement to report on whether a previously reported material weakness continues to exist must be performed by a person or persons having adequate technical training and proficiency as an auditor. In all matters related to the assignment, an independence in mental attitude must be maintained. Due professional care must be exercised in the performance of the engagement and the preparation of the report.

22. This standard establishes the fieldwork and reporting standards applicable to an engagement to report on whether a previously reported material weakness continues to exist.

23. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

The concept of materiality, as discussed in paragraph 20 of Auditing Standard No. 5, underlies the application of the general and fieldwork standards in an engagement to report on whether a previously reported material weakness continues to exist. The auditor should assess materiality as of the date that management asserts that the previously reported material weakness no longer exists.

Planning the Engagement

24. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

The auditor should properly plan the engagement to report on whether a previously reported material weakness continues to exist and should properly supervise any assistants. When planning the engagement, the auditor should evaluate how the matters described in paragraph 9 of Auditing Standard No. 5 will affect the auditor's procedures.

Obtaining an Understanding of Internal Control over Financial Reporting

25. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

To perform this engagement, the auditor must have a sufficient knowledge of the company and its internal control over financial reporting. An auditor who has audited the company's internal control over financial reporting in accordance with Auditing Standard No. 5 as of the date of the company's most recent annual assessment of internal control over financial reporting would be expected to have obtained a sufficient knowledge of the company and its internal control over financial reporting to perform this engagement.

[The following note is effective November 15, 2007. See PCAOB Release 2007-005.]

> Note: The second sentence of the paragraph above contemplates that the auditor's previous engagement under Auditing Standard No. 5 resulted in rendering an opinion. If an auditor previously engaged to perform an audit of internal control over financial reporting in accordance with Auditing Standard No. 5 has not yet rendered an opinion on the effectiveness of the company's internal control over financial reporting as of the company's most recent year-end or more recently, then that auditor should follow the requirements for a successor

auditor in paragraphs 26a-b and 27. Additionally, if an auditor has previously performed an audit of internal control over financial reporting at the company and is now a successor auditor (because another auditor has subsequently performed an audit of internal control over financial reporting at the company in intervening years), the auditor should follow the requirements in paragraphs 26 and 27 for a successor auditor.

26. When a successor auditor[3] performs an engagement to report on whether a previously reported material weakness continues to exist and he or she has not yet completed an audit of internal control over financial reporting at the company, he or she must perform procedures to obtain sufficient knowledge of the company's business and its internal control over financial reporting to achieve the objective of the engagement, as described in paragraph 5 of this standard. A successor auditor who has not yet completed an audit of internal control over financial reporting at the company must perform the following procedures as part of obtaining sufficient knowledge of the company's business and its internal control over financial reporting:

[The following subparagraph is effective November 15, 2007. See PCAOB Release 2007-005.]

a. Comply with paragraphs 22–27 of Auditing Standard No. 5 regarding obtaining an understanding of internal control over financial reporting. The extent of understanding of internal control over financial reporting needed to satisfy these requirements in the context of an engagement to report on whether a previously reported material weakness continues to exist depends on the nature of the material weakness on which the auditor is reporting. The more pervasive the effects of the material weakness, the more extensive the understanding of internal control over financial reporting should be under these requirements. For example, if the material weakness affects company-level controls, a more extensive understanding of internal control over financial reporting will be necessary than if the effects of the material weakness are isolated at the transaction level.

[The following subparagraph is effective November 15, 2007. See PCAOB Release 2007-005.]

b. Perform the procedures described in paragraphs 34–38 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, for those transactions that are directly affected by controls specifically identified by management as addressing the material weakness.

c. In addition to the communication requirements described in AU sec. 315, *Communications Between Predecessor and Successor Auditors*, the successor auditor should make specific inquiries of the predecessor auditor. These inquiries should address the basis for the predecessor auditor's determination that a material weakness existed in the company's internal control over financial reporting and the predecessor auditor's awareness of any information bearing on the company's ability to successfully address that material weakness.

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[3] The term *successor auditor* has the same meaning as the definition of that term in paragraph .02 of AU sec. 315, *Communications Between Predecessor and Successor Auditors*.

27. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

A successor auditor may determine that he or she needs to perform procedures in addition to those specified in paragraph 26 of this standard to obtain a sufficient knowledge of the company's business and its internal control over financial reporting. Depending on the nature of the company's business, its organization, its internal control over financial reporting, and the specific material weakness that is the subject of this engagement, a successor auditor may determine that he or she is not able to obtain a sufficient basis for reporting on whether a previously reported material weakness continues to exist without performing a complete audit of internal control over financial reporting in accordance with Auditing Standard No. 5.

Testing and Evaluating Whether a Material Weakness Continues to Exist

28. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

The auditor must obtain an understanding of and evaluate management's evidence supporting its assertion that the specified controls related to the material weakness are designed and operated effectively, that these controls achieve the company's stated control objective(s) consistent with the control criteria, and that the identified material weakness no longer exists. If the auditor determines that management has not supported its assertion with sufficient evidence, the auditor cannot complete the engagement to report on whether a previously reported material weakness continues to exist, because one of the conditions for engagement completion described in paragraph 7 of this standard would not be met.

29. As a part of evaluating management's evidence supporting its assertion, the auditor should determine whether management has selected an appropriate date for its assertion. In making this determination, the auditor should take into consideration the following:

a. Management's assertion that a previously reported material weakness no longer exists may be made as of any specified date that permits management to obtain sufficient evidence supporting its assertion.

   Note: The auditor also should determine whether the specified date of management's assertion permits the auditor to obtain sufficient evidence supporting his or her opinion.

b. Depending on the nature of the material weakness, the stated control objective, and the specified controls, the specified date of management's assertion may need to be after the completion of one or more period-end financial reporting processes.

c. Controls that operate daily and on a continuous, or nearly continuous, basis generally permit the auditor to obtain sufficient evidence as to their operating effectiveness as of almost any date management might choose to specify in its report.

d. Controls that operate over the company's period-end financial reporting process typically can be tested only in connection with a period-end.

30. The auditor should obtain evidence about the effectiveness of all controls specifically identified in management's assertion. The nature, timing, and extent of the testing that enables the auditor to obtain sufficient evidence supporting his or her opinion on whether a previously reported material weakness continues to exist will depend on both the nature of the controls specifically identified by management as meeting the company's stated control objectives and the date of management's assertion.

31. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

All controls that are necessary to achieve the stated control objective(s) should, therefore, be specifically identified and evaluated. The specified controls will necessarily include controls that have been modified or newly implemented and also may include existing controls that previously were deemed effective during management's most recent annual assessment of internal control over financial reporting. As part of testing and evaluating the design effectiveness of the specified controls, the auditor should determine whether the specified controls would meet the stated control objective(s) if they operated as designed. In making this evaluation, the auditor should apply paragraphs 42–43 of Auditing Standard No. 5.

32. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

Consistent with the direction in paragraphs 44–45 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, the auditor should test the operating effectiveness of a specified control by determining whether the specified control operated as designed and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively. In determining the nature, timing, and extent of tests of controls, the auditor should apply paragraphs 50–54 of Auditing Standard No. 5.

33. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

The auditor should perform tests of the specified controls over a period of time that is adequate to determine whether, as of the date specified in management's assertion, the controls necessary for achieving the stated control objective are operating effectively. The timing of the auditor's tests should vary with the risk associated with the control being tested. For example, a transaction-based, daily reconciliation generally would permit the auditor to obtain sufficient evidence as to its operating effectiveness in a shorter period of time than a pervasive, entity-level control, such as any of those described in paragraphs 22–24 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. Additionally, the auditor typically will be able to obtain sufficient evidence as to the operating effectiveness of controls over the company's period-end financial reporting process only by testing those controls in connection with a period-end.

34. The auditor should determine whether, based on the nature of the material weakness, performing substantive procedures to support recorded financial statement amounts or disclosures affected by the specifically identified controls is necessary to obtain sufficient evidence regarding the operating effectiveness of those controls. For example, a material weakness in the company's controls over the calculation of its bad debt reserve ordinarily would require that the auditor also perform substantive procedures to obtain sufficient evidence supporting an opinion about whether the material weakness continues to exist as of a specified date. In this circumstance, in addition to testing the design

and operating effectiveness of the controls specifically identified as achieving the company's stated control objective that its bad debt reserve is reasonably estimated and recorded, the auditor ordinarily would need to perform substantive procedures to determine that, as of that same specified date, the company's bad debt reserve was fairly stated in relation to the company's financial statements taken as a whole.

35. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

When the specified controls, stated control objectives, and material weakness affect multiple locations or business units of the company, the auditor may apply the relevant concepts in paragraphs B10–B16 of Appendix B of Auditing Standard No. 5 to determine the locations or business units at which to perform procedures.

Using the Work of Others

36. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

The auditor should evaluate whether to use the work performed by others in an engagement to report on whether a previously reported material weakness continues to exist. To determine the extent to which the auditor may use the work of others to alter the nature, timing, or extent of the work the auditor otherwise would have performed, the auditor should apply paragraphs 16–19 of Auditing Standard No. 5.

37. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

The auditor's opinion relates to whether a material weakness no longer exists at the company because the stated control objective(s) is met. Therefore, if the auditor has been engaged to report on more than one material weakness or on more than one stated control objective, the auditor must evaluate whether he or she has obtained sufficient evidence that the control objectives related to each of the material weaknesses identified in management's assertion are achieved. The auditor may, however, use the work of others to alter the nature, timing, or extent of the work he or she otherwise would have performed. For these purposes, the work of others includes relevant work performed by internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provide information about the effectiveness of internal control over financial reporting.

38. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

Paragraphs 18–19 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, should be applied in the context of the engagement to report on whether a previously reported material weakness continues to exist. There may, therefore, be some circumstances in which the scope of the audit procedures to be performed in this engagement will be so limited that using the work of others will not provide any tangible benefit to the company or its auditor. Additionally, the auditor should perform any walkthroughs himself or herself because of the degree of judgment required in performing this work.

39. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

The following example illustrates how to apply this section on using the work of others to this engagement.

> In this example, the company's previously reported material weakness relates to the company's failure to perform bank reconciliations at its 50 subsidiaries. The specified controls identified by the company are the timely preparation of complete and accurate reconciliations between the company's recorded cash balances and the company's cash balances as reported by its financial institution.
>
> Although certain controls over bank reconciliations are centralized, the performance of the bank reconciliations themselves is not centralized because they occur at each individual operating unit. Further, each operating unit has, on average, three separate cash accounts. The cash accounts affected are not material individually but are material in the aggregate. Most of the controls over the preparation of bank reconciliations involve a low degree of judgment in evaluating their operating effectiveness, can be subjected to objective testing, and have a low potential for management override.
>
> If these conditions describe the specified controls over the preparation of bank reconciliations, the auditor could determine that, based on the nature of the controls as described above, he or she could use the work of others to a moderate extent, provided that the degree of competence and objectivity of the individuals performing the tests is high. The auditor might perform tests of controls that are centralized at the holding company level himself or herself; perform testing at a limited number of locations himself or herself; test the work of others performed at a limited number of other locations; review the results of the work of others at all other locations tested; and determine that, qualitatively and quantitatively, principal evidence had been obtained.
>
> On the other hand, if the company's previously reported material weakness related to the company's failure to perform a reconciliation of its only cash account, few controls and few operations of those controls would underlie management's assertion that the material weakness no longer exists. In this circumstance, it is unlikely that the auditor would be able to use a significant amount of the work of others because of the limited scope of the total amount of work needed to test management's assertion and due to the requirement that the auditor obtain the principal evidence himself or herself.

Opinions, Based in Part, on the Work of Another Auditor

40. The auditor may apply the relevant concepts in AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, in an engagement to report on whether a previously reported material weakness continues to exist, with the following exception. If the auditor decides to serve as the principal auditor and to use the work and reports of another auditor as a basis, in part, for his or her opinion, the principal auditor must not divide responsibility for the engagement with the other auditor. Therefore, the principal auditor must not make reference to the other auditor in his or her report.

Forming an Opinion on Whether a Previously Reported Material Weakness Continues to Exist

41. When forming an opinion on whether a previously reported material weakness continues to exist, the auditor should evaluate all evidence obtained from all sources. This process should include an evaluation of the sufficiency of the evidence obtained by management and the results of the auditor's evaluation of the design and operating effectiveness of the specified controls.

42. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

Management may conclude that a previously reported material weakness no longer exists because its severity has been sufficiently reduced such that it is no longer a material weakness.

43. The auditor may issue an opinion on whether a previously reported material weakness continues to exist only when there have been no restrictions on the scope of the auditor's work. Because of the scope of an engagement to report on whether a previously reported material weakness continues to exist, any limitations on the scope of the auditor's work require the auditor either to disclaim an opinion or to withdraw from the engagement. A qualified opinion is not permitted.

> Note: As described in paragraph 51 of this standard, the auditor's opinion on whether a previously reported material weakness continues to exist may be expressed as "the material weakness exists" or "the material weakness no longer exists." Therefore, the provisions of this standard do not distinguish between an unqualified opinion and an adverse opinion and, instead, refer simply to "an opinion" or "the auditor's opinion."

Requirement for Written Representations

44. In an engagement to report on whether a previously reported material weakness continues to exist, the auditor should obtain written representations from management:

a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;

b. Stating that management has evaluated the effectiveness of the specified controls using the specified control criteria and management's stated control objective(s);

c. Stating management's assertion that the specified controls are effective in achieving the stated control objective(s) as of a specified date;

d. Stating management's assertion that the identified material weakness no longer exists as of the same specified date;

e. Stating that management believes that its assertions are supported by sufficient evidence;

[The following subparagraph is effective November 15, 2007. See PCAOB Release 2007-005.]

f. Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a misstatement in the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting and that has occurred or come to management's attention since the date of management's most recent annual assessment of internal control over financial reporting; and

g. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting

or other factors that might significantly affect the stated control objective(s) or indicate that the identified controls were not operating effectively as of, or subsequent to, the date specified in management's assertion.

45. The written representations should be signed by those members of management with overall responsibility for the company's internal control over financial reporting whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Such members of management ordinarily include the chief executive officer and chief financial officer or others with equivalent positions in the company.

46. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the engagement. As discussed further in paragraph 43 of this standard, if there is a limitation on the scope of an engagement to report on whether a previously reported material weakness continues to exist, the auditor must either disclaim an opinion or withdraw from the engagement. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations of management, including, if applicable, representations obtained in an audit of the company's financial statements.

Documentation Requirements

47. The documentation requirements in Auditing Standard No. 3, *Audit Documentation*, are modified in the following respect as they apply to this engagement. Paragraph 14 of Auditing Standard No. 3 defines the *report release date* as the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements. As described in paragraph 29 of this standard, management's assertion that a material weakness no longer exists may be made as of a date other than a period-end financial reporting date. Therefore, the auditor's release of a report on whether a previously reported material weakness continues to exist may not necessarily be associated with the issuance of financial statements of the company. Accordingly, in an engagement to report on whether a previously reported material weakness continues to exist, the report release date for purposes of applying Auditing Standard No. 3 is the date the auditor grants permission to use the auditor's report on whether a previously reported material weakness continues to exist.

Reporting on Whether a Previously Reported Material Weakness Continues to Exist

Management's Report

48. As a condition for the auditor's performance of this voluntary engagement, management is required to present a written report that will accompany the auditor's report, as described in paragraph 7e of this standard. To satisfy this condition for the auditor's performance of this engagement, management's report should include:

a. A statement of management's responsibility for establishing and maintaining effective internal control over financial reporting for the company;

b. A statement identifying the control criteria used by management to conduct the required annual assessment of the effectiveness of the company's internal control over financial reporting;

c. An identification of the material weakness that was identified as part of management's annual assessment;

Note: This report element should be modified in the case in which management's annual assessment did not identify the material weakness, but, rather, only the auditor's report on management's annual assessment identified the material weakness.

d. An identification of the control objective(s) addressed by the specified controls and a statement that the specified controls achieve the stated control objective(s) as of a specified date; and

e. A statement that the identified material weakness no longer exists as of the same specified date because the specified controls address the material weakness.

Auditor's Evaluation of Management's Report

49. With respect to management's report, the auditor should evaluate the following matters:

a. Whether management has properly stated its responsibility for establishing and maintaining effective internal control over financial reporting;

b. Whether the control criteria used by management to conduct the evaluation is suitable;

c. Whether the material weakness, stated control objectives, and specified controls have been properly described; and

d. Whether management's assertions, as of the date specified in management's report, are free of material misstatement.

50. If, based on the results of this evaluation, the auditor determines that management's report does not include the elements described in paragraph 48 of this standard, the conditions for engagement performance have not been met.

Auditor's Report

51. The auditor's report on whether a previously reported material weakness continues to exist must include the following elements:

a. A title that includes the word *independent*;

[The following subparagraph is effective November 15, 2007. See PCAOB Release 2007-005.]

b. A statement that the auditor has previously audited and reported on management's annual assessment of internal control over financial reporting as of a specified date based on the control criteria, as well as a statement that the auditor's report identified a material weakness;

Note: This report element should be modified in cases in which a successor auditor's performance of this engagement is occurring before he or she has opined on the effectiveness of internal control over financial reporting overall in accordance with Auditing Standard No. 5. In this circumstance, the auditor's report should refer to the predecessor auditor's report on management's annual assessment and the predecessor auditor's identification of the material weakness.

c. A description of the material weakness;

d. An identification of management's assertion that the identified material weakness in internal control over financial reporting no longer exists;

e. An identification of the management report that includes management's assertion, such as identifying the title of the report (if the report is titled);

f. A statement that management is responsible for its assertion;

g. An identification of the specific controls that management asserts address the material weakness;

Note: As discussed further in paragraph 31, all controls that are necessary to achieve the stated control objective should be identified.

h. An identification of the company's stated control objective that is achieved by these controls;

i. A statement that the auditor's responsibility is to express an opinion on whether the material weakness continues to exist as of the date of management's assertion based on his or her auditing procedures;

j. A statement that the engagement was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);

k. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the engagement to obtain reasonable assurance about whether a previously reported material weakness continues to exist at the company;

[The following subparagraph is effective November 15, 2007. See PCAOB Release 2007-005.]

l. A statement that the engagement includes examining evidence supporting management's assertion and performing such other procedures the auditor considered necessary in the circumstances and that the auditor obtained an understanding of internal control over financial reporting as part of his or her previous audit of management's annual assessment of internal control over financial reporting and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the material weakness;

Note: This report element should be modified in cases in which a successor auditor's performance of this engagement is occurring before he or she has opined on the effectiveness of internal control over financial reporting overall in accordance with Auditing Standard No. 5. In this circumstance, the auditor's report should include a statement that the engagement includes obtaining an understanding of internal control over financial reporting, examining evidence supporting management's assertion, and performing such other procedures as the auditor considered necessary in the circumstances.

m. A statement that the auditor believes the auditing procedures provide a reasonable basis for his or her opinion;

n. The auditor's opinion on whether the identified material weakness exists (or no longer exists) as of the date of management's assertion;

[The following subparagraph is effective November 15, 2007. See PCAOB Release 2007-005.]

o. A paragraph that includes the following statements:

- That the auditor was not engaged to and did not conduct an audit of internal control over financial reporting as of the date of management's assertion, the objective of which would be the expression of an opinion on the effectiveness of internal control over financial reporting, and that the auditor does not express such an opinion, and
- That the auditor has not applied auditing procedures sufficient to reach conclusions about the effectiveness of any controls of the company as of any date after the date of management's annual assessment of the company's internal control over financial reporting, other than the controls specifically identified in the auditor's report, and that the auditor does not express an opinion that any other controls operated effectively after the date of management's annual assessment of the company's internal control over financial reporting.

  Note: This report element statement should be modified in the case in which a successor auditor's performance of this engagement is occurring before he or she has opined on the effectiveness of internal control over financial reporting overall in accordance with Auditing Standard No. 5 to read as follows: That the auditor has not applied auditing procedures sufficient to reach conclusions about the effectiveness of any controls of the company other than the controls specifically identified in the auditor's report and that the auditor does not express an opinion that any other controls operated effectively.

p. A paragraph stating that, because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of the effectiveness of specific controls or internal control over financial reporting overall to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate;

q. The manual or printed signature of the auditor's firm;

r. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

s. The date of the auditor's report.

52. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

Example A-1 in Appendix A is an illustrative auditor's report for an opinion that a material weakness no longer exists, expressed by an auditor who has previously reported on the company's internal control over financial reporting in accordance with Auditing Standard No. 5 as of the company's most recent year-end (herein after referred to as a continuing auditor). Example A-2 in

Appendix A is an illustrative auditor's report for an opinion that a material weakness no longer exists expressed by a successor auditor.

53. As stated in paragraph 3 of this standard, the auditor may report on more than one previously reported material weakness as part of the same engagement. In this circumstance, the auditor should modify the report elements described in paragraph 51 of this standard accordingly.

54. *Report modifications.* The auditor should modify the standard report if any of the following conditions exist.

a. Other material weaknesses that were reported previously by the company as part of the company's annual assessment of internal control are not addressed by the auditor's opinion. (See paragraph 56 of this standard.)

b. A significant subsequent event has occurred since the date being reported on. (See paragraphs 57 and 58 of this standard.)

c. Management's report on whether a material weakness continues to exist includes additional information. (See paragraphs 59 through 60 of this standard.)

55. As described further in paragraph 43 of this standard, the form of the auditor's report resulting from an engagement to report on whether a previously reported material weakness continues to exist may be an opinion on whether a material weakness continues to exist, or it may be in the form of a disclaimer of opinion. A qualified opinion is not permitted. Any limitations on the scope of the auditor's work preclude the expression of an opinion. In addition to these reporting alternatives, an auditor may elect not to report on whether a material weakness continues to exist and, instead, withdraw from the engagement.

56. *Other material weaknesses reported previously by the company as part of the company's annual assessment of internal control are not addressed by the auditor's opinion.* In the circumstance in which the company previously has reported more than one material weakness, the auditor may be engaged to report on whether any or all of the material weaknesses continue to exist. If the auditor reports on fewer than all of the previously reported material weaknesses, the auditor should include the following or similar language in the paragraph that states that the auditor was not engaged to perform an audit of internal control over financial reporting. When referring to his or her previously issued report on management's annual assessment, the auditor should either attach that report or include information about where it can be publicly obtained.

> Our report on management's annual assessment of XYZ Company's internal control over financial reporting, dated [*date of report*], [attached or *identify location of where the report is publicly available*] identified additional material weaknesses other than the one identified in this report. We are not reporting on those other material weaknesses and, accordingly, express no opinion regarding whether those material weaknesses continue to exist after [*date of management's annual assessment, e.g., December 31, 200X*]. [*Revise this wording and references or attachments appropriately for use in a successor auditor's report.*]

Example A-3 in Appendix A is an illustrative report issued by a continuing auditor reporting on only one material weakness when additional material weaknesses previously were reported.

57. *Subsequent events.* A change in internal control over financial reporting or other factors that might significantly affect the effectiveness of the identified controls or the achievement of the company's stated control objective might occur subsequent to the date of management's assertion but before the date of the

auditor's report. Therefore, the auditor should inquire of management whether there was any such change or factors. As described in paragraph 44 of this standard, the auditor should obtain written representations from management regarding such matters. Additionally, to obtain information about whether such a change has occurred that might affect the effectiveness of the identified controls or the achievement of the company's stated control objective and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following:

- Internal audit reports (or similar functions, such as loan review in a financial institution) relevant to the stated control objective or identified controls issued during the subsequent period;
- Independent auditor reports (if other than the auditor's) of significant deficiencies or material weaknesses relevant to the stated control objective or identified controls;
- Regulatory agency reports on the company's internal control over financial reporting relevant to the stated control objective or identified controls; and
- Information about the effectiveness of the company's internal control over financial reporting relevant to the stated control objective or identified controls obtained as a result of other engagements.

58. If the auditor obtains knowledge about subsequent events that he or she believes adversely affect the effectiveness of the identified controls or the achievement of the stated control objective as of the date specified in management's assertion, the auditor should follow the requirements in paragraph 61 regarding special considerations when a material weakness continues to exist. If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the identified controls or the achievement of the stated control objective, the auditor should disclaim an opinion.

59. *Management's report includes additional information.* If management's report includes information in addition to the matters described in paragraph 48 of this standard, the auditor should disclaim an opinion on the additional information. For example, the auditor should use the following or similar language as the last paragraph of the report to disclaim an opinion on management's plans to implement new controls:

> We do not express an opinion or any other form of assurance on management's statement referring to its plans to implement new controls by the end of the year.

60. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information.

> Note: If management makes the types of disclosures described in paragraph 59 outside its report on whether a previously reported material weakness continues to exist and includes them elsewhere within a document that contains management's and the auditor's reports on whether a previously reported material weakness continues to exist, the auditor would not need to disclaim an opinion, as described in paragraph 59. However, in that situation, the auditor's responsibilities are the same as those described in this paragraph if the auditor believes that the additional information contains a material misstatement of fact.

Special Considerations When a Previously Reported Material Weakness Continues to Exist

61. If the auditor determines that the previously reported material weakness continues to exist and the auditor reports on the results of the engagement, he or she must express an opinion that the material weakness exists as of the date specified by management.

62. As described in paragraph 55, the auditor is not required to issue a report as a result of this engagement. If the auditor does not issue a report in this circumstance, he or she must communicate, in writing, his or her conclusion that the material weakness continues to exist to the audit committee. Similarly, if the auditor identifies a material weakness during this engagement that has not been previously communicated to the audit committee in writing, the auditor must communicate that material weakness, in writing, to the audit committee.

63. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

Additionally, whenever the auditor concludes that a previously reported material weakness continues to exist, the auditor must consider that conclusion as part of his or her evaluation of management's quarterly disclosures about internal control over financial reporting, as required by paragraphs .07 and .29–.32 of AU section 722, *Interim Financial Information*.

64. *[The following paragraph is effective November 15, 2007. See PCAOB Release 2007-005.]*

For example, if the auditor were engaged to report on whether two separate material weaknesses continue to exist and concluded that one no longer exists and one continues to exist, the auditor's report could comprise either of the following: (1) a report that contained two opinions, one on the material weakness that the auditor concluded no longer exists and one opinion on the material weakness that the auditor concluded continues to exist, or (2) a report that contained only a single opinion on the material weakness that the auditor concluded no longer exists if the company modifies its assertion to address only the material weakness that the auditor concluded no longer exists. In the second circumstance, the auditor must communicate, in writing, his or her conclusion that a material weakness continues to exist to the audit committee and also should apply paragraph 56 of this standard regarding other material weaknesses reported previously that are not addressed by the auditor's opinion. Additionally, the auditor must consider that conclusion as part of his or her evaluation of management's quarterly disclosures about internal control over financial reporting, as required by paragraphs .07 and .29–.32 of AU section 722, *Interim Financial Information*.

Effective Date

65. This standard is effective February 6, 2006.

Appendix A

Illustrative Reports on Whether a Previously Reported Material Weakness Continues to Exist

Paragraphs 51 through 60 of this standard provide direction on the auditor's report on whether a previously reported material weakness continues to exist. The following examples illustrate the application of those paragraphs.

Example A-1—*Illustrative Auditor's Report for a Continuing Auditor Expressing an Opinion that a Previously Reported Material Weakness No Longer Exists*

Example A-2—*Illustrative Auditor's Report for a Successor Auditor Expressing an Opinion that a Previously Reported Material Weakness No Longer Exists*

Example A-3—*Illustrative Auditor's Report for a Continuing Auditor Expressing an Opinion on Only One Previously Reported Material Weakness When Additional Material Weaknesses Previously Were Reported*

Example A-1

Illustrative Auditor's Report for a Continuing Auditor Expressing an Opinion That a Previously Reported Material Weakness No Longer Exists

Report of Independent Registered Public Accounting Firm

We have previously audited and reported on management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Our report, dated [*date of report*], identified the following material weakness in the Company's internal control over financial reporting:

[*Describe material weakness*]

We have audited management's assertion, included in the accompanying [title of management's report], that the material weakness in internal control over financial reporting identified above no longer exists as of [*date of management's assertion*] because the following control(s) addresses the material weakness:

[*Describe control(s)*]

Management has asserted that the control(s) identified above achieves the following stated control objective, which is consistent with the criteria established in [*identify control criteria used for management's annual assessment of internal control over financial reporting*]: [*state control objective addressed*]. Management also has asserted that it has tested the control(s) identified above and concluded that the control(s) was designed and operated effectively as of [*date of management's assertion*]. XYZ Company's management is responsible for its assertion. Our responsibility is to express an opinion on whether the identified material weakness continues to exist as of [*date of management's assertion*] based on our auditing procedures.

Our engagement was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the engagement to obtain reasonable assurance about whether a previously reported material weakness continues to exist at the company. Our engagement included examining evidence supporting management's assertion and performing such other procedures as we considered necessary in the circumstances. We obtained an understanding of the company's internal control over financial reporting as part of our previous audit of management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the material weakness described above. We believe that our auditing procedures provide a reasonable basis for our opinion.

In our opinion, the material weakness described above no longer exists as of [*date of management's assertion*].

We were not engaged to and did not conduct an audit of internal control over financial reporting as of [*date of management's assertion*], the objective of which would be the expression of an opinion on the effectiveness of internal control over financial reporting. Accordingly, we do not express such an opinion. This means that we have not applied auditing procedures sufficient to reach conclusions about the effectiveness of any controls of the company as of any date after

December 31, 200X, other than the control(s) specifically identified in this report. Accordingly, we do not express an opinion that any other controls operated effectively after December 31, 200X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness of specific controls or internal control over financial reporting overall to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-2

Illustrative Auditor's Report for a Successor Auditor Expressing an Opinion That a Previously Reported Material Weakness No Longer Exists

Report of Independent Registered Public Accounting Firm

We were engaged to report on whether a previously reported material weakness continues to exist at XYZ Company as of [*date of management's assertion*] and to audit management's next annual assessment of XYZ Company's internal control over financial reporting. Another auditor previously audited and reported on management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).*"]. The other auditor's report, dated [*date of report*], identified the following material weakness in the Company's internal control over financial reporting:

[*Describe material weakness*]

We have audited management's assertion, included in the accompanying [title of management's report], that the material weakness in internal control over financial reporting identified above no longer exists as of [*date of management's assertion*] because the following control(s) addresses the material weakness:

[*Describe control(s)*]

Management has asserted that the control(s) identified above achieves the following stated control objective, which is consistent with the criteria established in [*identify control criteria used for management's annual assessment of internal control over financial reporting*]: [*state control objective addressed*]. Management also has asserted that it has tested the control(s) identified above and concluded that the control(s) was designed and operated effectively as of [*date of management's assertion*]. XYZ Company's management is responsible for its assertion. Our responsibility is to express an opinion on whether the identified material weakness continues to exist as of [*date of management's assertion*] based on our auditing procedures.

Our engagement was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the engagement to obtain reasonable assurance about whether a previously reported material weakness continues to exist at the company. Our engagement included obtaining an understanding of internal control over financial reporting, examining evidence supporting management's assertion, and performing such other procedures as we considered necessary in the circumstances. We believe that our auditing procedures provide a reasonable basis for our opinion.

In our opinion, the material weakness described above no longer exists as of [*date of management's assertion*].

We were not engaged to and did not conduct an audit of internal control over financial reporting as of [*date of management's assertion*], the objective of which would be the expression of an opinion on the effectiveness of internal control over financial reporting. Accordingly, we do not express such an opinion. This means that we have not applied auditing procedures sufficient to reach conclusions about the effectiveness of any controls of the company other than the

control(s) specifically identified in this report. Accordingly, we do not express an opinion that any other controls operated effectively.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness of specific controls or internal control over financial reporting overall to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-3

Illustrative Auditor's Report for a Continuing Auditor Expressing an Opinion on Only One Previously Reported Material Weakness When Additional Material Weaknesses Previously Were Reported

Report of Independent Registered Public Accounting Firm

We have previously audited and reported on management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Our report, dated [*date of report*], identified the following material weakness in the Company's internal control over financial reporting:

[*Describe material weakness*]

We have audited management's assertion, included in the accompanying [title of management's report], that the material weakness in internal control over financial reporting identified above no longer exists as of [*date of management's assertion*] because the following control(s) addresses the material weakness:

[*Describe control(s)*]

Management has asserted that the control(s) identified above achieves the following stated control objective, which is consistent with the criteria established in [*identify control criteria used for management's annual assessment of internal control over financial reporting*]: [*state control objective addressed*]. Management also has asserted that it has tested the control(s) identified above and concluded that the control(s) was designed and operated effectively as of [*date of management's assertion*]. XYZ Company's management is responsible for its assertion. Our responsibility is to express an opinion on whether the identified material weakness continues to exist as of [*date of management's assertion*] based on our auditing procedures.

Our engagement was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the engagement to obtain reasonable assurance about whether a previously reported material weakness continues to exist at the company. Our engagement included examining evidence supporting management's assertion and performing such other procedures as we considered necessary in the circumstances. We obtained an understanding of the company's internal control over financial reporting as part of our previous audit of management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the material weakness described above. We believe that our auditing procedures provide a reasonable basis for our opinion.

In our opinion, the material weakness described above no longer exists as of [*date of management's assertion*].

We were not engaged to and did not conduct an audit of internal control over financial reporting as of [*date of management's assertion*], the objective of which would be the expression of an opinion on the effectiveness of internal control over financial reporting. Accordingly, we do not express such an opinion. This means that we have not applied auditing procedures sufficient to reach conclusions about the effectiveness of any controls of the company as of any date

after December 31, 200X, other than the control(s) specifically identified in this report. Accordingly, we do not express an opinion that any other controls operated effectively after December 31, 200X. Our report on management's annual assessment of XYZ Company's internal control over financial reporting, dated [*date of report*], [attached or *identify location of where the report is publicly available*] identified additional material weaknesses other than the one identified in this report. We are not reporting on those other material weaknesses and, accordingly, express no opinion regarding whether those material weaknesses continue to exist after [*date of management's annual assessment, e.g., December 31, 200X*].

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness of specific controls or internal control over financial reporting overall to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

[*Signature*]

[*City and State or Country*]

[*Date*]

Appendix B

Background and Basis for Conclusions

Introduction

B1. This appendix summarizes factors that the Public Company Accounting Oversight Board (the "Board") deemed significant in reaching the conclusions in the standard. This appendix includes reasons for accepting certain views and not accepting others.

Background

B2. Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") requires the management of public companies each year to file an assessment of the effectiveness of their companies' internal control over financial reporting. The company's independent auditor must attest to, and report on, management's assessment. Under the Securities and Exchange Commission's (the "SEC" or "Commission") implementing rules, company management may not conclude that internal control over financial reporting is effective if one or more material weaknesses exists.

B3. When a company reports a material weakness, investors may be left uncertain about the reliability of the company's financial reporting. Both companies and report users have recognized the importance of a mechanism for alerting investors that a previously disclosed material weakness no longer exists.[1] The federal securities laws provide part of that mechanism. Those laws require the company to disclose to investors any changes in internal control over financial reporting that occurred during the company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.[2] Therefore, investors will learn of material improvements, such as the remediation of a material weakness, on a timely basis through quarterly disclosures.[3]

B4. When a company determines that a material weakness has been remediated, it may determine that disclosure is sufficient. Some investors and companies, however, have called for the ability to bolster confidence in management's assertions about those internal control improvements with the added assurance of the company's independent auditor.[4]

B5. The Board reviewed its existing auditing and attestation standards to determine whether adequate standards governing such an engagement already existed. The Board's interim attestation standards provide requirements for general attest engagements; however, the Board determined that these standards

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[1] The Board's Standing Advisory Group ("SAG") discussed possible auditor involvement with the elimination of a material weakness at its November 18, 2004, public meeting. The webcast of the November 18, 2004 SAG discussion and the related briefing paper on this topic, "Reporting on the Correction of a Material Weakness," are available on the Board's Web site at www.pcaobus.org.

[2] See Item 308(c) of Regulation S-K, 17 C.F.R. §229.308(c).

[3] In addition, even if internal control over financial reporting is effective as of the end of a company's fiscal year, investors also could potentially learn if it deteriorates materially during the year through these quarterly disclosures.

[4] The Standing Advisory Group's November 18, 2004 discussion included this type of encouragement.

lack sufficient specificity for this purpose.[5] The Board, therefore, proposed an auditing standard that would be tailored narrowly to an engagement to report on whether a previously reported material weakness continues to exist.

B6. The Board received 30 comment letters on its proposal, primarily from auditor and investor groups as well as from two issuers. Those comments led to changes in the standard, intended to make the requirements of the standard clearer and more operational. This appendix summarizes significant views expressed in those comment letters and the Board's responses.

Voluntary Nature of Engagement

B7. The proposed standard explicitly stated that the engagement described by this standard is voluntary and that the standards of the PCAOB did not require an auditor to undertake this engagement when a material weakness was previously reported. In addition, the Board stressed the voluntary nature of this engagement at the public meeting proposing this standard.

B8. The value and importance of the Board's standards providing the option of this type of auditor reporting on a material weakness was confirmed unanimously in the comment letters from investors and investor-related parties. Auditors were also supportive of the standard overall and its voluntary nature. Both of the issuers who commented indicated that they would be concerned if issuers become compelled to obtain such opinions. One of these commenters stressed that the disclosure requirements of management, coupled with enhanced criminal penalties, should provide investors with information regarding the continued existence or correction of a material weakness.

B9. The Board continues to believe that providing for this type of auditor reporting in its standards will serve the public interest. At the same time, the Board reaffirms that reporting on whether a material weakness continues to exist is a voluntary engagement and is not required by the standards of the PCAOB.

Form of the Auditor's Opinion

B10. The proposed standard called for the auditor to express a single opinion directly on the subject matter (i.e., the material weakness itself), rather than on management's assertion, as follows:

> In our opinion, XYZ Company has eliminated the material weakness described above as of [*date of management's assertion*] because the stated control objective is met as of [*date of management's assertion*].

B11. Primarily auditors commented on the form of the opinion in the proposed standard and their comments reflected a wide spectrum of ideas. Some commenters expressed support for the auditor's report, including the form of the

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[5] See AT sec. 101, "Attest Engagement" of the Board's interim standards. Effective April 16, 2003, the PCAOB adopted, on an initial, transitional basis, five temporary interim standards rules (PCAOB Rules 3200T, 3300T, 3400T, 3500T, and 3600T) that refer to pre-existing professional standards of auditing, attestation, quality control, ethics, and independence (the "interim standards"). These rules were approved by the SEC on April 25, 2003. See SEC Release No. 33-8222. On December 17, 2003, the Board approved technical amendments to the interim standards rules indicating that, "when the Board adopts a new auditing and related professional practice standard that addresses a subject matter that also is addressed in the interim standards, the affected portion of the interim standards will be superseded or effectively amended. Accordingly, the Board approved adding the phrase 'to the extent not superseded or amended by the Board' to each of the interim standards rules." *Technical Amendments to Interim Standards Rules*, PCAOB Release No. 2003-26 (Dec. 17, 2003); Exchange Act Release No. 49624 (Apr. 28, 2004) (SEC Approval). The interim standards are available on the Board's Web site at www.pcaobus.org.

opinion as proposed. Other comments included a suggestion for two opinions, consistent with Auditing Standard No. 2—one on the subject matter (the elimination of the material weakness) and one on management's assertion. Other commenters suggested that just one opinion was sufficient, though these commenters were split regarding whether the one opinion should be on management's assertion or on the subject matter. Other commenters suggested that an opinion stating that the material weakness had been eliminated, without the phrase "because the stated control objective is met" would be a better alternative, while others asked the Board to consider an opinion stating that the identified controls were effective because the stated control objective was met, without stating that the material weakness had been eliminated.

B12. A number of commenters expressed concern with the phrasing "the material weakness has been eliminated," including the use of that phrase in the auditor's opinion and in the title of the proposed standard. These commenters believed that terminology such as "elimination" or "eliminated" might be too definite a term that might mislead report users into believing that there were no remaining deficiencies in the internal control over financial reporting in the area related to the specified material weakness, even though control deficiencies of a lesser severity than a material weakness might persist.

B13. After considering these suggestions, the Board decided to retain a single opinion on the subject matter and to revise the opinion wording. The Board continues to believe that a single opinion expressed directly on the subject matter is the simplest and clearest form of communication related to this engagement. Further, the Board believes that an auditor's opinion directly on the subject matter (i.e., the material weakness itself) will best achieve the overarching objective of this engagement—to clearly communicate as of an interim date auditor assurance about whether a previously reported material weakness continues to exist.

B14. The Board agreed with commenters that use of the term "elimination" might increase the risk that a report user would misunderstand the assurance provided by an auditor's opinion on a previously reported material weakness. As a result, the Board changed the form of the opinion to "In our opinion, the material weakness described above no longer exists as of [date of management's assertion]" and the title of the standard to "Reporting on Whether a Previously Reported Material Weakness Continues to Exist." The text of the standard was modified throughout to delete references to "eliminated" or "elimination" and to reflect wording consistent with the revised opinion and title.

As-of Date of Report

B15. The proposed standard provided for significant flexibility by allowing the engagement to be undertaken at any time during the year, limited only by implications associated with the nature of the material weakness. In other words, the proposed standard did not require the engagement to be performed in conjunction with an audit or review of financial statements. Instead, the proposed standard required the auditor to determine whether management had selected an appropriate date for its assertion and specified several matters for the auditor to consider in making this determination.

B16. A number of auditors suggested that the engagement described by the proposed standard should be performed only as of quarterly financial reporting dates instead of as of any date during the year. These commenters believed that such a requirement would allow the auditor to integrate this work with the auditor's interim review procedures under AU sec. 722, *Interim Financial Information*, and provide a link between the auditor's report on the material

weakness and management's quarterly disclosures of material changes in internal control. Commenters noted that many of the material weaknesses that have been disclosed to date are related to the period-end financial reporting process and that the auditor would therefore need to test controls in connection with a period-end to determine whether the material weakness continues to exist. Several commenters linked their suggestion that this engagement be performed only as of a quarterly financial reporting date to the view that the standard's direction on performing substantive procedures as part of this engagement should be bolstered (see separate discussion on performance of substantive procedures beginning at paragraph B51). One commenter pointed out, however, that if this engagement could be conducted only in connection with a quarterly financial reporting date, special guidance for applying the standard to foreign filers would be necessary because foreign filers are not required to report quarterly in the same manner as domestic filers.

B17. The Board believes that the flexibility provided in the proposed standard regarding the timing of the engagement is an important and appropriate feature of the standard. Although the Board agrees with commenters' observations that many of the material weaknesses disclosed during the past year were related to the period-end financial reporting process, the Board determined that the existing provisions of the proposed standard address this circumstance. In determining whether management has selected an appropriate date for its assessment, the standard requires the auditor to consider that controls that operate over the company's period-end financial reporting process typically can be tested only in connection with a period-end.

B18. Moreover, some material weaknesses—such as those that involve transaction-based controls that operate daily—are well suited for a management assertion and an auditor opinion that the material weakness no longer exists as of almost any date. Restricting an auditor's reporting on whether a material weakness continues to exist to only quarterly financial reporting dates could impose unnecessary delay on a company seeking auditor assurance that this type of material weakness no longer exists. For example, assume that a calendar year-end company had previously disclosed a material weakness that was the type that would lend itself well to reporting that it no longer existed as of any date. Further, management could not yet assert that the material weakness no longer existed as of March 31, but believed that it could make the assertion as of a date in April. If the standard restricted auditor reporting to a quarterly financial reporting date, the auditor would have to wait until June 30 to be able to attest to whether the material weakness continued to exist (and, presumably, would not be able to issue his or her report until July, at the earliest). While management could, in this example, provide timely disclosure to investors that the material weakness no longer existed, the Board concluded that structuring the provisions of the standard to potentially result in this kind of delay in auditor assurance would not serve the public interest.

B19. In light of these considerations, the Board decided to retain the provisions of the proposed standard that would permit the auditor to report on whether a previously reported material weakness continues to exist as of any date.

B20. At least one auditor asked for clarification about whether a report issued pursuant to Auditing Standard No. 2 that identified a material weakness could be issued at the same time as a report pursuant to this standard indicating that the material weakness no longer exists as of a later date. The degree of flexibility regarding the timing of this engagement would permit the company (depending on the company's ability to assert that a material weakness no longer exists and the auditor's ability to timely audit that assertion) to simultaneously distribute its annual reports and the management assertion and auditor report

described in this standard. Consistent with this flexible approach, nothing in this standard or Auditing Standard No. 2 would preclude the auditor from issuing a single, combined report on the results of an audit of internal control over financial reporting pursuant to Auditing Standard No. 2 and the results of an engagement performed pursuant to this standard.

Applicability of the Standard to Material Weaknesses Not Previously Reported

B21. The proposed standard was structured to allow an auditor to report only on a previously reported material weakness. The proposed standard defined a previously reported material weakness as a material weakness that was previously described by an auditor's report issued pursuant to Auditing Standard No. 2. A material weakness initially identified *after* the company's annual assessment date could not, therefore, be the subject of an auditor's report under the proposed standard.

B22. Virtually all of the investors who submitted comment letters suggested that the standard should allow for auditor reporting on material weaknesses identified subsequent to the company's most recent annual assessment of internal control over financial reporting. Although some of these commenters expressed concern about the level of work that might be required of the auditor to thoroughly understand a material weakness not previously reported upon by an auditor, they did not believe that the standard should prohibit such reporting. One commenter stated that if a successor auditor could gain an understanding of a company's internal control sufficient to report on a material weakness that was identified and reported on by a predecessor auditor, an auditor should be able to gain the understanding necessary to report on a material weakness identified by management as of an interim date.

B23. The majority of the auditors who commented indicated strong opposition to allowing auditors to report in this engagement on material weaknesses not previously reported. These commenters suggested that the initial identification of a material weakness requires a level of understanding of the company's controls and the specific facts and circumstances surrounding the material weakness that can result only from a complete evaluation of the effectiveness of internal control over financial reporting. Additionally, at least one commenter expressed concern that the identification of a material weakness subsequent to the annual assessment is a strong indicator of a material change within the company's internal control over financial reporting. This commenter believed that in such a circumstance the auditor would not have sufficient knowledge of the current state of internal control over financial reporting to be able to consider the interaction and potential implications of the change on other controls. This commenter also believed that this situation would prevent the auditor, in most cases, from being able to determine whether the newly identified material weakness no longer exists.

B24. The Board decided to retain the approach described by the proposed standard. The Board believes that the issue of a newly identified material weakness being an indicator of a material change within a company's internal control over financial reporting is a valid concern. Although the change in internal control over financial reporting giving rise to any new material weakness may be confined specifically to the area in which the material weakness originally was identified, the change also could be more far-reaching. In such circumstances, the auditor may not be able to determine the effect of the change without performing a full audit of internal control over financial reporting.

B25. The Board also notes that there is an important distinction between material weaknesses previously identified in an auditor's report issued pursuant to Auditing Standard No. 2 and other newly identified material weaknesses. The primary purpose of the narrow engagement described by this standard is to establish a timely and reasonable mechanism that a company can use to remove any perceived "stain" upon its financial reporting due to an outstanding adverse audit opinion on internal control over financial reporting that identified a material weakness. In the case of a new material weakness that is identified and addressed by management as of an interim date, an adverse auditor opinion previously attesting to the material weakness would not exist and, therefore, the new material weakness would not be the subject of the same type of market focus.

B26. There is also a fundamental difference between the auditor reporting on a material weakness not previously reported and a successor auditor reporting on a material weakness that *was* reported in a predecessor auditor's opinion on internal control over financial reporting. The fundamental difference is the concept of material change described above. The successor auditor must obtain a sufficient understanding of the company's internal control over financial reporting to report on the existence of a material weakness that was previously reported. This successor auditor, however, has the benefit of knowing that the material weakness was identified in the context of an audit of the internal control over financial reporting as a whole and that the predecessor auditor should have adequately described the nature of the material weakness (particularly its pervasiveness and the extent of its effect on the company's financial reporting). In contrast, in situations in which a material change has taken place and a new material weakness has arisen after the previous annual assessment of internal control over financial reporting, neither the predecessor nor the successor auditor has obtained this level of understanding as it relates to the newly identified material weakness.

B27. These considerations, taken together, resulted in the Board's decision to retain the provisions of the proposed standard that limit this engagement only to material weaknesses that have been previously described in an auditor's report issued pursuant to Auditing Standard No. 2. The Board also made changes to the standard, as suggested by one commenter, to make these provisions clearer. These changes included changing the title of the standard to "Reporting on Whether a Previously Reported Material Weakness Continues to Exist" as well as conforming changes to the text of the standard to refer explicitly to a *previously reported* material weakness as the subject matter of this engagement.

Focus on Control Objectives

B28. The proposed standard focused on stated control objectives to determine whether a material weakness continues to exist and posited that if a material weakness has been disclosed previously, a necessary control objective at the company has not been achieved. Because the term "stated control objective" was not precisely defined elsewhere in the Board's auditing standards, the proposed standard provided a definition as well as examples of stated control objectives.

B29. A *stated control objective* in the context of this engagement is the specific control objective identified by management that, if achieved, would result in the material weakness no longer existing. The stated control objective would provide management and the auditor with a specific target against which to evaluate whether the material weakness continues to exist. For this reason, the proposed standard required that management and the auditor be satisfied

that if the stated control objective were achieved the material weakness would no longer exist.

B30. Comments on the proposed standard's focus on control objectives came primarily from auditors. Many auditors, either explicitly or implicitly, supported the focus on control objectives. One auditor suggested that, given the importance of control objectives, the proposed standard should explicitly state that documentation of control objectives is required.

B31. Several auditors, however, expressed concerns about the proposed standard's focus on control objectives. A couple of these commenters suggested that the proposed standard's emphasis on control objectives might inappropriately establish a framework for evaluating the effectiveness of internal control over financial reporting that differs from, or otherwise adversely affects the proper application of, the Committee of Sponsoring Organizations of the Treadway Commission's publication *Internal Control—Integrated Framework* ("COSO").

B32. Most concerned commenters expressed apprehension that report users might be misled by an auditor's opinion that a material weakness had been eliminated because the control objectives had been met. They believed that this type of opinion might lead report users to mistakenly believe that if the control objectives were met, there were no remaining deficiencies in the internal control over financial reporting in the area related to the material weakness—when, in fact, a significant deficiency or deficiency could continue to exist.

B33. Another commenter noted that the examples in the proposed standard illustrated only control objectives for the control activities component of internal control over financial reporting—not for the other components (control environment, risk assessment, monitoring, information and communication). This commenter suggested that examples of control objectives in the other components would be helpful. Another commenter suggested that, given the importance of the control objective concept, if the Board's standards were to specifically address the concept, such a definition and discussion should reside in Auditing Standard No. 2. One concerned auditor concluded that, given the importance of control objectives, more guidance was needed, including clarification that if more than one control is necessary to achieve a stated control objective, all such controls must be identified and tested as part of this engagement.

B34. In response to comments, the Board decided to retain the definition of, and focus on, control objectives and provide additional guidance. The Board views the auditor's use of the concept of control objectives as analogous to the use of the concept of relevant assertions. The concept of relevant assertions was already familiar to experienced auditors and was specifically defined for the first time in Auditing Standard No. 2 because of that standard's focus on testing controls over all relevant assertions related to all significant accounts. Similarly, the concept of control objectives is familiar to most experienced auditors and is already used to describe the auditor's responsibilities under Auditing Standard No. 2).[6] A definition of control objectives (and stated control objectives) is

[6] For example, paragraph 12 of Auditing Standard No. 2 states, "Therefore, effective internal control over financial reporting often includes a combination of preventive and detective controls to achieve a specific control objective." Paragraph 85 of Auditing Standard No. 2 elaborates on this idea, including the example that, when performing tests of preventive and detective controls, the auditor might conclude that a deficient preventive control could be compensated for by an effective detective control and, therefore, not result in a significant deficiency or material weakness. That paragraph concludes with the statement, "When determining whether the detective control is effective, the auditor should evaluate whether the detective control is sufficient to achieve the control objective to which the [deficient] preventive control relates." Perhaps most notably, paragraph 88 of Auditing Standard No. 2 requires the auditor to identify the company's control objectives in each area and identify the controls that satisfy each control objective to evaluate whether the company's internal control over financial reporting is designed effectively.

provided in this standard because of the standard's focus on control objectives as a specific measure for determining whether a material weakness continues to exist. This is consistent with the Board's objective for its standards to be clear as well as the focus on control objectives in the engagement described by this standard.

B35. The Board believes that the standard's focus on control objectives is sound and helpful and is an appropriate complement to the control criteria, such as COSO, for the purposes of this engagement. The process of tailoring control objectives to the individual company allows the control criteria (i.e., the evaluation framework) used for management's annual assessment to be applied to the facts and circumstances in a reasonable and appropriate manner. Accordingly, the emphasis in this standard on control objectives is consistent with, and supports a correct application of, COSO.

B36. The focus on whether the stated control objectives have been met as the target for determining whether a material weakness continues to exist does accommodate the circumstance in which a deficiency or significant deficiency continues to exist in that area of the company's internal control over financial reporting. Although several commenters linked this result with the focus on control objectives, this potential result would exist in any case within the overall construct of this standard, completely apart from the focus on control objectives. The potential for less severe deficiencies to persist in an area in which a previously reported material weakness no longer exists parallels the reporting results of an engagement performed under Auditing Standard No. 2. According to that standard, only material weaknesses (not less severe weaknesses) are disclosed in an auditor's report and only the existence of a material weakness and not less severe weaknesses affects the auditor's opinion on the effectiveness of the company's internal control over financial reporting. As an illustration, assume that a company that had previously reported a material weakness in internal control over financial reporting elected to wait until the auditor's next annual report issued pursuant to Auditing Standard No. 2 to obtain auditor assurance related to the existence of the material weakness. If the control weakness that had previously risen to the level of material weakness were reduced to a significant deficiency or deficiency as of the company's next year-end, the auditor's next report issued under Auditing Standard No. 2 would present an unqualified opinion indicating that the company's internal control over financial reporting was effective. The Board concluded that the users of an auditor's report on whether a previously reported material weakness continues to exist need only receive auditor assurance that the material weakness no longer exists and not more detailed information about whether less severe control deficiencies continue to persist.

B37. The Board notes, however, that paragraph 140 of Auditing Standard No. 2 states (in part) that strong indicators of a material weakness include circumstances in which significant deficiencies that have been communicated to management and the audit committee remain uncorrected after some reasonable period of time. If management does not plan to correct the significant deficiency within a reasonable period of time, the auditor should evaluate whether the remaining significant deficiency could be indicative of a material weakness in internal control over financial reporting. An auditor is not required to provide an opinion under this voluntary engagement, and could reasonably decline to provide an opinion under such circumstances.

B38. In response to comments that report users will mistakenly believe that an auditor's report issued pursuant to the standard's provisions is communicating auditor assurance that no control deficiencies exist in the area related to the former material weakness, the Board decided that the change in the title of the

standard and the form of the auditor's opinion (discussed further in paragraph B14), coupled with this discussion, would sufficiently mitigate any potential for report users to misunderstand the assurance being provided by an engagement conducted under this standard. Removing the concept of control objectives from the standard would not address the potential for misunderstanding because this potential exists independently of the focus on control objectives.

B39. With regard to the recommendation that the standard provide additional examples of stated control objectives, including stated control objectives related to components of internal control over financial reporting other than control activities, the Board determined that the provisions of the standard should remain largely at the conceptual level and state that the other components of internal control over financial reporting can be expressed in terms of control objectives. The Board also determined to emphasize, in the note to paragraph 17 of the standard, that when a material weakness has a pervasive effect on the company's internal control over financial reporting, it may be difficult to identify all of the relevant control objectives and the material weakness probably is not suitable for this type of narrow, interim reporting.

B40. For the purposes of this engagement, a stated control objective need not be more precise than to describe an objective that relates to whether there is a more than remote risk that the company's financial statements are materially misstated in a given area. For instance, paragraph 14 of the standard includes the example control objective, "The company has legal title to recorded product X inventory in the company's Dallas, TX warehouse." This example assumes that the product X inventory account related to the company's Dallas, TX warehouse represents a more than remote risk of material misstatement to the company's financial statements taken as a whole and has been identified as a separate significant account. This example does not suggest that a company should establish separate control objectives for all of its various types of inventory, by inventory location, regardless of materiality.

B41. Although the Board believes that the proposed standard made clear that in performing this engagement, the auditor should identify and test all controls necessary to achieve the stated control objective, based on the importance of this concept and in response to commenters, the Board concluded that an explicit clarification should be added. Not only must newly implemented or modified controls be identified and tested in this engagement, but *all* controls necessary to achieve the stated control objective must be identified and tested. For example, in a circumstance in which four controls must operate effectively for a given control objective to be achieved, the failure of one of those controls could result in a material weakness. In the context of this engagement, all four controls necessary to achieve the stated control objective would need to be specifically identified and tested. This must be the case because of the inherent limitations in internal control over financial reporting. If three of the four controls were found to be effective as of year-end, they cannot be assumed to be effective as of a later date. To render an opinion as of a current date about whether the material weakness exists, the auditor must have current evidence about whether all controls (in this example, all four controls) necessary to achieve the control objective are designed and operating effectively.

B42. Regarding the suggestion to include a requirement that control objectives be documented, the Board notes that neither COSO nor Auditing Standard No. 2 currently contain such a requirement. As with many aspects of assessing the effectiveness of internal control over financial reporting, the better the documentation, the easier and more efficient the evaluation, especially from the auditor's perspective. In the context of this engagement, by virtue of creating a stated control objective, the company and the auditor would document the

stated control objective, even if that documentation appeared only in their respective reports. Therefore, documentation is effectively required for the stated control objectives encompassed by an engagement conducted under this standard. The Board does not believe, however, that establishing a broad requirement for documenting *all* control objectives related to a company's internal control over financial reporting is needed at this time or would be appropriately placed within this standard.

Concept of Materiality

B43. To provide direction on the concept of materiality, the proposed standard largely referred to Auditing Standard No. 2. The proposed standard stated that the concept of materiality, as discussed in paragraphs 22 and 23 of Auditing Standard No. 2, underlies the application of the general and fieldwork standards in an engagement to report on whether a previously reported material weakness continues to exist. Therefore, the auditor uses materiality at the financial-statement level, rather than at the individual account-balance level, in evaluating whether a material weakness exists.

B44. Several auditors commented that the proposed standard should provide additional direction on how the auditor considers materiality in performing this engagement. Commenters believed that clarification was necessary regarding the appropriate time context for management's and the auditor's materiality judgments. These commenters asked whether materiality should be assessed as of the date management asserts to be the date at which the material weakness no longer exists, or as of the end of the prior year when the material weakness was originally reported.

B45. Most commenters on this issue suggested that the date for assessing materiality should be the date management asserts to be the date at which the material weakness no longer exists. Commenters noted, however, that this position would allow a material weakness to no longer exist merely as a result of a business acquisition or disposition, for example, because either of those actions would change materiality as of that point in time (and, in the case of a disposition, send the material weakness along with the disposed business).

B46. Several auditors suggested that the auditor's opinion should explicitly recognize the concept of materiality. Commenters suggested the following as alternatives that would recognize materiality: "Management's assertion that XYZ Company has eliminated the material weakness described above as of [*date of management's assertion*] is fairly stated, in all material respects . . ." and "XYZ Company has eliminated the material weakness with respect to the Company's internal control over financial reporting as described above as of [*date specified in management's assertion*], in all material respects." These commenters were concerned that the opinion described by the proposed standard misrepresented the precision of the auditor's assessment and neglected the notion of reasonable assurance.

B47. The Board decided that the provisions in the standard regarding materiality should be clarified to specify that materiality should be assessed as of the date management asserts that the material weakness no longer exists. The as-of date of management's assertion and the auditor's opinion is fundamental to the auditor's decisions about whether he or she has obtained sufficient evidence to support an opinion and to the auditor's evaluation of that evidence to form an opinion on whether the material weakness exists as of that point in time. The Board believes that the logical and internally consistent position regarding the time context for assessing materiality is to assess materiality as of the date that management asserts the material weakness no longer exists. The Board also believes that materiality can be assessed as of a date other than a financial

reporting period-end. This is consistent with the Board's decision, discussed further beginning at paragraph B15, that the standard permit the auditor to report on whether a previously reported material weakness continues to exist as of any date.

B48. The Board also believes that auditors should exercise caution in circumstances in which the only aspect of a previously reported material weakness that has changed is materiality (in other words, the size of the financial statement accounts has changed due to an acquisition or other activity rather than any changes in the design or operation of controls). In many such cases, the company will have undergone significant changes, with an associated change in internal control over financial reporting overall. In this circumstance, the auditor would need to perform procedures beyond the scope of work ordinarily contemplated under this standard to have a sufficient basis for his or her new assessment of materiality and an adequate understanding of the company's internal control over financial reporting overall. The Board believes that, in many cases in which the company has undergone a change of this magnitude, the auditor would need to perform a full audit of internal control over financial reporting in accordance with Auditing Standard No. 2 to have a sufficient basis for assessing materiality, understanding the company's internal control over financial reporting overall, and rendering an opinion about whether a material weakness continues to exist. Also, as discussed in paragraph B37, a previously reported material weakness may no longer exist because it has been reduced to a significant deficiency. In this circumstance, if management does not plan to correct the significant deficiency within a reasonable period of time, the auditor should evaluate whether the remaining significant deficiency could be indicative of a material weakness.

B49. Regarding the form of the auditor's opinion and concerns that the opinion suggested by the proposed standard implied an inappropriate degree of precision and neglected the concept of reasonable assurance, the Board concluded that the provisions of the proposed standard were sufficiently clear that the auditor's objective in this engagement was to plan and perform the engagement to obtain reasonable assurance about whether a previously reported material weakness continues to exist as of the date specified by management. Furthermore, the auditor's report described by the proposed standard included disclosure of this objective. The Board does not, therefore, believe that report users would mistakenly believe that the auditor's opinion, as proposed, would convey absolute assurance.

B50. In addition, the Board believes that including another reference to materiality in the auditor's opinion would not add anything of substance to the auditor's conclusion and could instead impair its readability. The determination of whether a material weakness exists is inherently linked to materiality. Stating that the material weakness no longer exists in all material respects would be redundant—the equivalent of saying that the financial statements are not materially misstated in all material respects. Accordingly, the Board has not added another reference to materiality in the auditor's opinion.

Performance of Substantive Procedures

B51. The proposed standard, consistent with its reliance on the existing provisions of Auditing Standard No. 2, focused largely on the tests of controls that the auditor must perform to obtain reasonable assurance that a material weakness no longer exists. The proposed standard additionally recognized that, in some cases, the auditor also would need to perform substantive procedures on account balances to obtain sufficient evidence as to whether a material weakness no longer exists.

B52. Several auditors believed that the proposed standard was too mild in its wording that the auditor "may determine" that performing substantive procedures was necessary. Those commenters believed that, to be consistent with the integrated audit concept of Auditing Standard No. 2 and to reflect the fact that identification of many material weaknesses during the past year occurred during the performance of substantive audit procedures, such wording did not adequately convey the importance of performing substantive procedures in an engagement to report on whether a previously reported material weakness continues to exist. Some commenters recommended that the standard set forth a presumptively mandatory requirement for the auditor to perform substantive audit procedures in all cases, while others suggested that strengthening the language or providing additional guidance about when substantive procedures are necessary would be sufficient.

B53. The Board continues to believe that in some circumstances, substantive procedures will not be necessary for the auditor to obtain sufficient evidence about whether a material weakness continues to exist. Like many aspects of this standard, the auditor's judgment in this area will depend on the nature of the material weakness. An auditor can obtain sufficient evidence to support an opinion on whether some material weaknesses continue to exist without the need for substantive procedures. Other material weaknesses necessitate substantive procedures for the auditor to obtain sufficient evidence. Therefore, the Board determined that it would be inappropriate to establish a presumptively mandatory requirement that substantive procedures be performed in all cases.

B54. The Board agreed, however, that the proposed standard did not sufficiently stress the potential importance of performing substantive procedures, depending on the nature of the material weakness. Paragraph 34 of the standard has, therefore, been modified in a manner that the Board believes better articulates the potential need to perform substantive procedures. An example also has been added to this paragraph of the standard to illustrate a circumstance in which substantive procedures ordinarily would need to be performed.

Using the Work of Others

B55. Similar to PCAOB Auditing Standard No. 2, the proposed standard permitted the auditor to use the work of others to alter the nature, timing, and extent of the auditor's performance of this work. Specifically, the proposed standard applied the framework for using the work of others described in PCAOB Auditing Standard No. 2. That framework requires the auditor to obtain the principal evidence supporting his or her opinion and to evaluate the nature of the controls being tested, together with the competence and objectivity of the persons performing the work.

B56. Under both PCAOB Auditing Standard No. 2 and the proposed standard, the framework measures principal evidence in relation to the overall assurance provided by the auditor. In PCAOB Auditing Standard No. 2, the principal evidence supporting the auditor's opinion should be evaluated in relation to the auditor's opinion on internal control over financial reporting overall. In contrast, the evaluation of whether the auditor has obtained the principal evidence supporting his or her opinion as to whether a material weakness no longer exists would need to be applied at the control objective level.

B57. There were few comments on the provisions for using the work of others in this proposed standard. Most commenters who commented on these provisions expressed confusion about a passage in the example of proposed paragraph 36, which stated that "the auditor *might* perform a walkthrough of the reconciliation process himself or herself [emphasis added]." Commenters believed that

walkthroughs were required in the proposed standard in all cases and that walkthroughs must be conducted by the auditor himself or herself.

B58. One auditor suggested clarifying within the proposed standard that the auditor will be able to use the work of others only in limited circumstances. This same commenter also believed that the bank reconciliation example presented in the proposed standard to illustrate how the auditor could use the work of others in this type of engagement was too simplistic and requested additional, more realistic examples.

B59. The Board continues to believe that the framework for using the work of others that was established in Auditing Standard No. 2 is appropriate for use in this context and, therefore, the provisions for using the work of others in the standard have been retained as proposed. At the same time, the Board determined that it would be helpful to clarify, through the following discussion, that the evaluation of whether the auditor has obtained the principal evidence supporting his or her opinion on whether a material weakness continues to exist would need to be applied at the control objective level. A complete understanding of this feature of the standard is important because this provision allows for additional flexibility in the auditor's work.

B60. The auditor's opinion in this engagement is expressed only on whether the material weakness continues to exist—not on whether the individually identified controls are effective. As a result, the evaluation as to whether the auditor has obtained the principal evidence supporting his or her opinion should be made at the control objective level—not at the lower level of the controls individually identified in management's assertion and the auditor's report.

B61. If, for example, management's and the auditor's reports identify three separate previously reported material weaknesses that no longer exist, the auditor would, in effect, be rendering three separate opinions. Those opinions would indicate that each of the three individual material weaknesses continues to exist or no longer exists as of the date of management's assertion. The standard, therefore, would require the auditor to obtain the principal evidence that the *control objectives* related to each of the three identified material weaknesses were now achieved. However, the standard would not require that the auditor obtain the principal evidence that each *control specifically identified* in management's assertion as achieving the control objectives is effective.

B62. Auditing Standard No. 4 follows the same framework for using the work of others as Auditing Standard No. 2. There may, however, be some circumstances in which the scope of the audit procedures to be performed in this engagement will be so limited that using the work of others will not provide any tangible benefit to the company or its auditor. The Board believes that no additional specific restriction on the use of the work of others is appropriate or necessary in the context of this engagement. Such a restriction would diminish the flexibility that the framework otherwise provides and perhaps inhibit the auditor's exercise of the judgment necessary to implement the framework appropriately. Furthermore, the Board does not believe that auditors need such direction within the standard to make appropriate decisions about using the work of others in this context.

B63. Similarly, the Board determined that no further examples of using the work of others were needed. The Board believes that additional examples demonstrating the application of the provisions in the standard for using the work of others to reflect more realistic (i.e., complex, fact-driven) situations is better handled outside of the standard itself and by auditors—in their audit methodology, training courses, and other venues.

B64. In response to confusion about the requirement for walkthroughs, the Board clarified the standard by adding a note to paragraph 38 and deleted the reference to a walkthrough from the example on using the work of others. Walkthroughs are required only of a successor auditor when the successor auditor performs this engagement before performing an audit of internal control over financial reporting in accordance with Auditing Standard No. 2. A continuing auditor that has opined already on the company's internal control over financial reporting in accordance with Auditing Standard No. 2 as of the company's most recent annual assessment and is engaged to conduct this narrow engagement is not required to perform any walkthroughs as part of this engagement.

Dividing Responsibility

B65. Due to the narrow scope of an engagement to report on whether a material weakness continues to exist, the provisions of the proposed standard allowed the principal auditor to use the work and reports of another auditor as a basis, in part, for his or her opinion. The proposed standard also prohibited the principal auditor from dividing responsibility for the engagement with another auditor.

B66. Very few comments were received on this provision of the proposed standard. One auditor suggested that, although dividing responsibility may not be appropriate in certain circumstances, the standard should not prohibit it. Another auditor expressed confusion about whether the principal auditor could refer to the report of the other auditor but not divide responsibility with the other auditor.

B67. The Board continues to believe that, based on the nature of the engagement described by the standard, the principal auditor should be prohibited from dividing responsibility for the engagement with another auditor. The Board's consideration of the nature of this engagement included recognition of the narrow scope of the work (i.e., whether a previously reported material weakness continues to exist), that the engagement would be voluntary, and that the assignment would be non-recurring (unlike the recurring nature of the audit of the financial statements or the audit of internal control over financial reporting). The Board notes that three appropriate alternatives exist in the circumstance in which another auditor is involved and the company wants to obtain auditor assurance that a previously reported material weakness no longer exists:

- The principal auditor could report on whether a previously reported material weakness continues to exist according to this standard by performing all of the testing required for this engagement himself or herself.
- The principal auditor could report on whether a previously reported material weakness continues to exist according to this standard by using the work and reports of another auditor as a basis, in part, for his or her opinion, and by taking responsibility for the work performed by the other auditor. In this case, the auditor may not make reference to the other auditor in his or her report on whether a previously reported material weakness continues to exist.
- The company could wait until year-end when the principal auditor would report on the effectiveness of internal control over financial reporting overall under the provisions of Auditing Standard No. 2.

B68. The Board concluded that the standard was sufficiently clear that the principal auditor could not divide responsibility with another auditor and, therefore, that the auditor also could not refer to the other auditor in his or her report. Accordingly, no change has been made to the standard in this regard.

New Material Weaknesses Identified

B69. The proposed standard was silent regarding the auditor's responsibilities if, during the performance of this engagement, he or she became aware of a new material weakness not previously reported on by an auditor.

B70. Several commenters requested that the standard address the auditor's responsibilities for new material weaknesses identified during this engagement and suggested what these responsibilities should be. One investor suggested that the standard should require the auditor to include disclosure of any new material weaknesses of which the auditor was aware in his or her report. This commenter stated that, otherwise, the auditor's report would become a way of telling investors the good news while concealing the bad news. Another commenter suggested that management should be required to include the new material weakness in management's assertion that would accompany the auditor's report and the auditor should then disclaim an opinion on the new material weakness.

B71. Both the identification of material weaknesses and the remediation of such weaknesses will be captured by management's voluntary and required reporting under the SEC's rules. Accordingly, the provisions of this standard do not facilitate management's ability to conceal from investors the emergence of a new material weakness at the company. Nevertheless, the Board agreed that when an auditor identifies a new material weakness during the performance of this engagement, the auditor should not simply remain silent. Accordingly, the Board modified the standard to require the auditor to communicate, in writing, to the audit committee any material weaknesses identified during this engagement that the auditor had not previously communicated, in writing, to the audit committee.

B72. The existing provisions of Auditing Standard No. 2 contain responsibilities for the auditor if (1) information comes to the auditor's attention during this engagement that leads him or her to believe, while performing quarterly procedures required by Auditing Standard No. 2, that management's quarterly disclosures are materially misleading, or (2) the auditor becomes aware of conditions that existed at the date of his or her last report issued under Auditing Standard No. 2.

B73. Paragraphs 202-206 of Auditing Standard No. 2 establish certain requirements for the auditor related to management's quarterly and annual certifications with respect to the company's internal control over financial reporting. If matters come to the auditor's attention during this engagement that lead him or her to believe, while fulfilling these quarterly requirements, that modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of Section 302 of the Act and the SEC's rules, these provisions of Auditing Standard No. 2 require the auditor to take action. Such actions escalate from auditor communications with management and then to the audit committee, culminating in the auditor considering his or her additional responsibilities under AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.

B74. In addition, a continuing or predecessor auditor would have responsibilities under paragraph 197 of Auditing Standard No. 2 if the existence of a new material weakness came to the auditor's attention. This paragraph effectively extends the responsibilities in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, to reports on the effectiveness of internal control over financial reporting issued pursuant to Auditing Standard No. 2. The identification of a new material weakness in the current year would cause

the auditor, in fulfilling these responsibilities, to determine whether the facts relating to the material weakness existed at the date of the auditor's report pursuant to Auditing Standard No. 2 and, if so, (1) whether those facts would have changed the auditor's report issued under Auditing Standard No. 2 if he or she had been aware of them and (2) whether there are persons currently relying on or likely to rely on the auditor's report. If the auditor determined that the new material weakness identified in the current year actually existed as of the date of his or her previous report under Auditing Standard No. 2 and that it was not adequately identified and disclosed in that report, the auditor would need to take steps such as recalling and reissuing the previous report to ensure that investors did not continue to rely on the previously issued (erroneous) report.

B75. Including newly identified material weaknesses in the auditor's report could potentially mislead investors into believing that the assurance provided by this type of engagement is broader than it actually is. If report users were provided with disclosure (covered by the auditor's opinion) of new material weaknesses of which the auditor was aware, report users might incorrectly believe that the auditor's report captured *all* new material weaknesses that had arisen at the company. Similarly, a requirement for the auditor to disclose any new material weaknesses could lead report users to conclude, incorrectly, that no such disclosure means that there is current auditor assurance over the whole of internal control over financial reporting at the company. The objective of this engagement is to provide auditor assurance about whether a previously reported material weakness continues to exist—nothing broader. The only way for investors to obtain a more complete report from the auditor would be for the auditor to audit internal control over financial reporting in accordance with Auditing Standard No. 2.

Specific Identification of All Previously Reported Material Weaknesses

B76. The proposed standard required the auditor to modify his or her report if the auditor provides assurance on less than all of the material weaknesses previously reported. The proposed standard did not, however, require the auditor to specifically identify all of the previously reported material weaknesses not covered.

B77. All investors who commented on this issue suggested that all material weaknesses previously reported either should be referred to or specifically included in the auditor's report. They indicated that failure to identify the additional material weaknesses might lead some users to erroneously conclude that they no longer exist. Auditors, on the other hand, agreed that complete specific identification of the previously reported material weaknesses not covered by the auditor's opinion should not be included, primarily because they believe that it may increase the risk of confusion about the scope of the engagement and what is being covered in the auditor's opinion. Several commenters who agreed that specific identification was not necessary suggested that in addition to the report modification included in the proposed standard, the auditor's report on this engagement should specifically direct the reader to the previous auditor's report (issued under Auditing Standard No. 2), by either attaching a copy of the audit report or by providing direction as to where the report could be obtained.

B78. The Board believes that including a complete specific identification of the previously reported material weaknesses not covered by this engagement would prove problematic. As noted by many commenters, it is possible that including this detail would confuse report readers regarding the scope of this narrow engagement and could imply that, unless told otherwise, a report user should

assume that those other material weaknesses *do* continue to exist. In some of the material weakness descriptions included in management's and the auditor's reports on the effectiveness of the company's internal control over financial reporting as of year-end, the description of multiple material weaknesses covered several pages. That level of detail in an auditor's report specifically targeted at whether just one material weakness continues to exist could easily overwhelm the rest of the audit report, making the report prone to various kinds of misinterpretations.

B79. The Board concluded that report readers would be better served by requiring the auditor to provide information regarding where to obtain the previously issued audit report—either by attaching it or referring to where it could be publicly obtained.

Other Reporting Matters

B80. *No Requirement to Issue a Report.* The proposed standard required that the auditor, if he or she concluded that the material weakness continues to exist, communicate that conclusion in writing to the audit committee. The proposed standard, however, did not require the issuance of a report. Rather, the proposed standard recognized that the auditor must consider this knowledge in connection with the auditor's responsibilities under Auditing Standard No. 2 to determine whether management's quarterly disclosures about internal control over financial reporting are not materially misleading.

B81. Several auditors who commented recommended that the proposed standard should require the auditor to issue an adverse report in the event that the auditor concludes that the material weakness continues to exist. One suggested that issuance of an adverse report would be necessary only if the auditor believed that the company had previously publicly disclosed that the material weakness had been addressed.

B82. The Board continues to believe that requiring the issuance of an adverse report to the company would serve no useful purpose in this circumstance because the company might not make such a report public. The Board believes, therefore, that requiring the auditor to communicate, in writing, with the audit committee his or her conclusion that a material weakness that was the subject of this engagement continues to exist would serve the same purpose as requiring the issuance of an adverse report. At the same time, such a requirement would provide the auditor with additional flexibility as to the form of communication that would be most meaningful to the audit committee. Regarding the potential for management to lead investors to incorrectly believe that the material weakness no longer exists in its public disclosures, the Board believes that the federal securities laws, as well as auditor's existing responsibilities related to management's quarterly disclosures, are adequate safeguards to protect investors from misleading information.

B83. *No Distinction in Standard Between Unqualified and Adverse Opinion.* As discussed in the note to paragraph 43 of the standard, the standard no longer distinguishes between an unqualified and an adverse opinion. The auditor's opinion was revised to state that the material weakness exists or no longer exists. This revision is discussed further in the section "Form of Auditor's Opinion" and is now referred to in the standard as the auditor's opinion.

B84. *Inherent Limitations.* The inherent limitations paragraph of the auditor's report provided in the proposed standard discussed the inherent limitations of internal control over financial reporting overall, rather than the inherent limitations of the controls related to the material weakness being reported on.

B85. One commenter suggested that the inherent limitations paragraph was too broad for this engagement and needed to be modified to more accurately reflect the narrow focus of this type of engagement.

B86. The Board agreed that the inherent limitations paragraph, in this context, should be targeted to the specific controls identified in this auditor report. In addition, the Board continues to believe that the broader concept of inherent limitations in internal control over financial reporting overall is equally applicable. The inherent limitations paragraph in the auditor's report has been modified to reflect both of these conclusions.

B87. *Obtaining an Understanding of Internal Control Over Financial Reporting.* The proposed standard included a required report element stating that "the engagement includes obtaining an understanding of internal control over financial reporting, examining evidence supporting management's assertion, and performing such other procedures as the auditor considered necessary in the circumstances." This language also was included in the example report included in the proposed standard.

B88. Several auditors expressed concern that the phrase, "the engagement includes obtaining an understanding of internal control over financial reporting," implies that, as a part of the current engagement, the auditor spent a significant amount of time understanding internal control over financial reporting overall rather than carrying forward his or her understanding from the prior annual audit. These commenters believed this implication conflicted with the direction in the body of the proposed standard that an auditor who has audited the company's internal control over financial reporting within the past year in accordance with Auditing Standard No. 2 would be expected to have obtained a sufficient knowledge of the company and its internal control over financial reporting to perform this engagement. One commenter acknowledged that the proposed wording may be appropriate in cases in which a successor auditor is performing this engagement without previously gaining that understanding.

B89. The Board continues to believe that an auditor who has audited the company's internal control over financial reporting as of the company's most recent annual assessment in accordance with Auditing Standard No. 2 would be expected to have obtained a sufficient knowledge of the company and its internal control over financial reporting to perform an engagement to report on whether a previously reported material weakness continues to exist. To require a continuing auditor to update and document his or her understanding of internal control over financial reporting overall (to the full measure required by Auditing Standard No. 2) would be unnecessarily burdensome and costly. The Board modified the report element for a continuing auditor to clarify that the auditor previously obtained an understanding of internal control over financial reporting overall at the company and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the specified material weakness.

B90. The Board continues to believe, however, that a successor auditor that has not yet audited the company's internal control over financial reporting in accordance with Auditing Standard No. 2 would need to obtain a current understanding of internal control over financial reporting in connection with this engagement. Therefore, the report element described in the proposed standard is appropriate and has been retained for a successor auditor's reporting.

B91. *Example Reports.* The proposed standard included only one example report, which illustrated reporting on one material weakness by a continuing auditor when no additional material weaknesses were reported previously. Several commenters requested modification of the standard to address circumstances that the Board believed were already addressed by the proposed

standard but were not illustrated in the single example report. Some commenters also made specific requests for additional example reports.

B92. The Board determined, after considering the nature of the comments, that additional example reports, while not covering all possible situations, would provide additional clarity to the various reporting situations. The Board selected three reports to illustrate most facets of the reporting provisions of the standard. Appendix A includes those reports.

Conforming Amendments to AT sec. 101

B93. The proposed standard contained a proposed conforming amendment to AT sec. 101, *Attest Engagements*. The proposed conforming amendment would have required the proposed standard to be used, rather than AT sec. 101, for any engagements in which the subject matter is whether a material weakness continues to exist. This conforming amendment would have precluded the auditor from performing an agreed-upon procedures or review engagement (using AT sec. 101) when the subject matter of the engagement was whether a material weakness continues to exist.

B94. The Board received few comments related to the proposed conforming amendment. One auditor agreed that a conforming amendment to preclude a review-level attestation was appropriate when the subject matter was whether a material weakness continues to exist. This commenter went on to suggest, however, that there could be appropriate uses for an agreed-upon procedures engagement and that the Board should not preclude agreed-upon procedures from being performed under the Board's standards. Such reports, the commenter noted, would be restricted to the use of the specified parties who take responsibility for the sufficiency of the agreed-upon procedures for their purposes and, therefore, these reports would not generally be available to investors. Thus, these reports would not be a substitute for the engagements addressed in the proposed standard. Another commenter separately suggested broadly retaining the ability for the auditor to perform a review engagement when the subject matter is a previously reported material weakness.

B95. The Board continues to believe that investors and other report users in the public domain will be best served by the Board's standards permitting only positive assurance (i.e., an examination-level attestation) from the auditor when the subject matter is whether a material weakness continues to exist. The Board agrees, however, that private parties (such as audit committees) who wish to engage the auditor to perform specified procedures when the subject matter is whether a material weakness continues to exist should be allowed to negotiate such a private arrangement, as long as the results are not intended for public use. The Board, therefore, decided to modify the conforming amendment to AT sec. 101 of the Board's interim standards. As adopted, an auditor may not use AT sec. 101 to report on whether a material weakness in internal control over financial reporting continues to exist for any purpose other than the company's internal use.

Attachment

PCAOB Release No. 2005-015

July 26, 2005
PCAOB Rulemaking
Docket Matter No. 018

Approved by the Securities and Exchange Commission on February 6, 2006, and is effective as of February 6, 2006.

Summary:

After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") has adopted Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*. The Board will submit this standard to the Securities and Exchange Commission ("Commission" or "SEC") for approval pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 (the "Act"). This standard will not take effect unless approved by the Commission.

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* * *

I. Background

Congress enacted Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") to provide investors with increased transparency about public companies' internal control over financial reporting. Since then, approximately 12.7 percent of public companies that are accelerated filers[1] have reported that their internal control over financial reporting is not effective because one or more material weaknesses in internal control over financial reporting existed as of the company's fiscal year-end.[2] When a company reports a material weakness, investors may be left uncertain about the reliability of the company's financial reporting. They may also want information about the company's plans for remediating the material weakness and its timeframe for doing so, and to be notified when the material weakness has been eliminated. Thus, a disclosure that internal control over financial reporting is not effective is often only the beginning of a company's communications with investors concerning the material weakness (or weaknesses) that caused the problem.[3]

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[1] An "accelerated filer," as defined in Rule 12b-2 under the Securities Exchange Act of 1934, 17 C.F.R. § 240.12b-2, is generally a U.S. company that, among other things, has equity market capitalization over $75 million and has filed at least one annual report with the Commission.

[2] See Paul J. Martinek, Adjustments, Restatements Are Predictors Of Weaknesses, Compliance Week (June 14, 2005).

[3] Some companies with material weaknesses have already begun this process by including detailed descriptions of their remediation plans in their annual filings or by providing additional disclosures in subsequent filings on the steps they are continuing to take to remediate the weaknesses. SeeJune 2005 Internal Control Report: All About Remediation, Compliance Week (July 6, 2005).

Both companies and report users have recognized the importance of a mechanism for companies to effectively communicate with the markets when a previously reported material weakness in internal control over financial reporting no longer exists.[4] In many cases, companies will find the mechanisms for company disclosures already provided by the federal securities laws sufficient. For example, a public company is required to disclose quarterly any changes in internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.[5] Investors will, therefore, learn of material improvements, such as the correction of a material weakness, on at least a quarterly basis through these required disclosures.[6] Under the Board's Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Connection with an Audit of Financial Statements*, the company's auditor is responsible for evaluating these quarterly disclosures.[7] Finally, investors will also learn about the status of previously reported material weaknesses (as well as internal control over financial reporting overall), accompanied by auditor assurance, when the company files its next annual report. Investors and issuers, however, have called for the ability to obtain auditor assurance as of an interim date that a previously reported material weakness no longer exists. At the November 18, 2004, SAG Meeting, several members of the group with experience as investors and issuers encouraged the Board to develop a standard that would describe this type of engagement for the auditor. In particular, several issuer members of the SAG emphasized that companies that have reported a material weakness will want to have options available to assure the markets that the material weakness has been remediated.[8]

II. Public Comment on the Board's Proposal

On March 31, 2005, the Board issued for public comment a proposed auditing standard titled "Reporting on the Elimination of a Material Weakness." In response, the Board received 30 comment letters from a variety of interested parties, including auditors, investors, issuers, and others. The comment letters included detailed discussion of a wide range of topics. Many commenters expressed strong support for the standard.[9]

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[4] The Board's Standing Advisory Group ("SAG") discussed possible auditor involvement with the elimination of a material weakness at its November 18, 2004 public meeting ("SAG Meeting"). An archived webcast of the SAG Meeting and a related briefing paper on this topic, "Reporting on the Correction of a Material Weakness," are available on the PCAOB's Web site at www.pcaobus.org.

[5] See Item 308(c) of Regulation S-K, 17 C.F.R. §229.308(c).

[6] Of course, through this same mechanism, investors also could learn if internal control over financial reporting deteriorates materially during the year.

[7] See Paragraphs 202–206 of Auditing Standard No. 2, as well as PCAOB Staff Question and Answer No. 55 regarding the extent of these responsibilities. The Staff Questions and Answers are available on the Board's Web site under Standards at www.pcaobus.org.

[8] See Nick S. Cyprus, Vice President, Controller and Chief Accounting Officer, The Interpublic Group of Companies, Remarks at SAG Meeting (Nov. 18, 2004) ("I guarantee there will be demand [for such a standard]"); Sam Cotterell, Vice President and Controller, Boise Cascade LLC, Remarks at SAG Meeting (Nov. 18, 2004) ("if I have a material weakness disclosed, I want a mechanism to let the market know that that has been fixed. I want to do that as quickly as possible.").

[9] See Letter from Laurie Fiori Hacking, Executive Director, Ohio Public Employees Retirement System, to J. Gordon Seymour, Acting Secretary, PCAOB (Apr. 15, 2005) ("The elimination of a material weakness, accompanied by an independent auditor's interim report attesting to management's assessment of its internal controls, will increase investor confidence in the reliability of a company's financial statements."); Letter from Gregory J. Jonas, Managing Director, Moody's Investors Service, to Office of the Secretary, PCAOB (May 5, 2005) ("the proposed standard strikes a useful balance by giving companies the option to provide users with information they value and with the assurance they find useful while not requiring a complete re-assessment").

Other comments included:

- suggestions regarding the wording of the auditor's opinion and the title of the proposed standard;
- discussion of several technical issues, such as the standard's focus on control objectives, consideration of materiality, and the potential need for the auditor to perform substantive procedures;
- suggestions regarding the auditor's responsibility when new material weaknesses are identified during this engagement, and when all previously reported material weaknesses are not being reported upon by the auditor;
- concerns that, although an engagement under the standard would be completely voluntary, it could become compulsory, as a practical matter, if investors begin to insist on auditor attestation in all cases in which a material weakness is identified;
- a suggestion that the conforming amendment be modified to allow auditors to use AT 101 strictly for a company's internal use.

The Board carefully considered all of the comment letters that it received. A detailed analysis of comments and the Board's responses are contained in the Background and Basis for Conclusions, in Appendix B of the standard.

III. Summary of Changes to the Proposed Standard

The Board adopted Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, after making several changes to the proposed standard in response to comments. The more significant changes include—

- revising the form of the auditor's opinion to clarify that the purpose of the engagement is to determine whether the material weakness "exists" or "no longer exists" and making related changes to the title of the standard;
- conforming text in the conditions for engagement performance to the text of a parallel provision in PCAOB Auditing Standard No. 2, due to the close relationship between the two standards. Specifically, the Board clarified that under Auditing Standard No. 4, management's evidence includes documentation;
- adding guidance on the subjects of materiality, control objectives and substantive procedures;
- adding a responsibility for the auditor to inform the audit committee if the auditor identifies a new material weakness during an engagement performed under this standard;
- modifying the required elements of the auditor's report to clarify that a continuing auditor previously obtained an understanding of internal control over financial reporting and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the specified material weakness;
- including additional illustrative auditor's reports; and
- modifying the conforming amendment to the Board's interim attestation standards to allow auditors to continue to use AT 101

for engagements to report on whether a material weakness continues to exist if such a report is intended strictly for a company's internal use.

These changes have been reflected in the adopted standard, and are discussed further in the Background and Basis for Conclusions, included in Appendix B of the standard.

IV. Overview of the Engagement

This standard establishes a stand-alone engagement that is entirely voluntary, performed only at the company's request. This type of reporting is not required by the Act or the standards or rules of the PCAOB, and should not be viewed as compulsory. The Board anticipates that in deciding whether to engage their auditors to report on whether a particular material weakness continues to exist, companies will weigh the costs and benefits and do so only when it is cost-effective. Based on the investor and issuer comments at the SAG Meeting, the Board believes that, in some situations, companies will find that auditor assurance that a material weakness no longer exists leads to a higher level of investor confidence in a company's financial reporting, and that the costs of the engagement are therefore worth incurring. If a company believes, however, that these benefits would be outweighed in a particular case by the costs of obtaining them, the company may (and presumably would) determine not to engage its auditor to perform this work.

Although the Board designed this standard to be a cost-effective means of providing investors assurance that a material weakness no longer exists, the Board expects that this engagement will be best suited and most cost-effective for reporting on material weaknesses that are discrete problems with a limited effect on the company's internal control over financial reporting. Reporting on material weaknesses that have a pervasive effect on the company's internal control over financial reporting could require such a broad and extensive base of work that the Board anticipates that a company in this situation would choose to wait for the auditor's annual audit of internal control over financial reporting conducted under Auditing Standard No. 2 to obtain auditor assurance that a pervasive material weakness no longer exists.

The objective of an auditor's engagement under this standard is to express an opinion on whether a previously reported material weakness continues to exist. The standard, therefore, draws from many concepts applicable to the auditor's report on the effectiveness of internal control over financial reporting, as described in Auditing Standard No. 2, although in a more narrowly focused and limited manner. For this reason, most of the requirements in the standard will be familiar to auditors. In designing this standard, the Board provided flexibility wherever possible, to allow auditors to conduct the engagement in a manner suited to the material weakness in internal control over financial reporting at issue.

Similar to any other attestation service, an auditor's report under this standard is based on an evaluation of management's assertion that the material weakness no longer exists. This standard establishes several conditions that must be met for the auditor to perform this engagement. These conditions were patterned after management's responsibilities under the SEC's rules implementing Section 404 of the Act[10] and the corresponding conditions in Auditing Standard No. 2.[11] These conditions include management accepting

[10] See Item 308(a) of Regulation S-K, 17 C.F.R. §229.308(a).

[11] See Paragraph 20 of Auditing Standard No. 2.

responsibility for internal control over financial reporting, evaluating the effectiveness of the specified controls that address the material weakness, asserting that the specified controls are effective in addressing the material weakness, and supporting its assertion with sufficient evidence, including documentation.

The auditor's assurance resulting from this engagement is that the previously reported material weakness, in the auditor's opinion, no longer exists as of a specified date. Although the auditor's evaluation of the design and operating effectiveness of the identified controls generally follows the requirements of PCAOB Auditing Standard No. 2, this engagement is designed to be significantly narrower in scope because the auditor's testing is limited to the controls specifically identified by management as addressing the material weakness. Both management and the auditor use the company's stated control objective as the target for determining whether the specified controls sufficiently address the material weakness. (See Section VI for further discussion of the determination that a material weakness no longer exists.)

V. Auditor's Report

To communicate clearly the narrow focus of this engagement, the standard requires the auditor's report to describe the material weakness, identify all of the specified controls that management asserts address the material weakness, and identify the stated control objective achieved by these controls. The report also is required to include language to emphasize to readers that the auditor has not performed procedures sufficient to reach conclusions about the effectiveness of any other controls or provided an opinion regarding the effectiveness of internal control over financial reporting overall.[12] Report users should thus understand the limited scope of the auditor's opinion.

To render an opinion that a material weakness no longer exists, the auditor must have obtained evidence about the design and operation of the relevant controls, determined that the material weakness no longer exists, and determined that no scope limitations were placed on the auditor's work. Because of the narrow focus of this engagement, qualified opinions are not permitted. Limitations on the scope of the auditor's work preclude the auditor from rendering an opinion. The auditor's opinion as to whether a previously reported material weakness continues to exist may be expressed as "the material weakness exists" or "the material weakness no longer exists." Accordingly, the standard does not distinguish between an unqualified opinion and an adverse opinion but simply refers to the auditor's opinion.

Unlike an auditor's report on internal control over financial reporting, in which the assessment is required to be as of the date of the annual financial statements, an auditor's report on whether a material weakness continues to exist may be as of any date set by management. The "as of" date of management's assertion represents the day the company believes the material weakness no longer exists and that the company has adequately assessed the effectiveness of the specified controls that address the material weakness. In the event that the auditor begins testing and concludes that additional remediation is required to

[12] The SAG Meeting included a discussion about the importance of such a report clearly communicating to report users the scope of the engagement. Several SAG members emphasized the potential for report users to believe, mistakenly, that the auditor, as a result of this limited engagement, had rendered a current opinion regarding the effectiveness of internal control over financial reporting overall. Comments received on the proposed standard generally expressed overall support for the clarity of the proposed auditor's report in this regard.

address the material weakness, the company has the opportunity to re-address its remediation efforts, reset the assertion date, and ask the auditor again to opine on whether the material weakness continues to exist.

If the auditor determines that a material weakness continues to exist and does not issue a report, the standard requires the auditor to communicate to the company's audit committee, in writing, his or her conclusion that the material weakness continues to exist. Similarly, the auditor also has a responsibility to communicate to the audit committee, in writing, any new material weaknesses that the auditor identifies during this engagement that the auditor has not already communicated in writing to the audit committee. The standard also addresses the circumstance in which the auditor reports on fewer than all of the previously reported material weaknesses. In this circumstance, the standard requires the auditor to include language in his or her report stating that his or her previously issued report on management's annual assessment of the company's internal control over financial reporting identified additional material weaknesses, that the auditor is not reporting on those other material weaknesses, and that the auditor, accordingly, is expressing no opinion on whether those material weaknesses exist after the company's year-end.[13]

VI. Determining that a Material Weakness No Longer Exists

The standard requires the auditor to obtain evidence sufficient to determine whether the design and operation of the controls identified by management achieve the *stated control objectives* and that the material weakness no longer exists. A control objective for internal control over financial reporting generally relates to a relevant financial statement assertion, such as whether certain recorded transactions are genuine, and provides a basis for evaluating the effect of a company's controls on that assertion.[14] A stated control objective in the context of this engagement is the specific control objective identified by management that, if achieved, would result in the material weakness no longer existing. For this reason, management and the auditor must be satisfied that, if the stated control objective were achieved, the material weakness would no longer exist.

When a material weakness has a pervasive effect on the company's internal control over financial reporting, identifying the control objectives that are not being met may be difficult because of the large number of control objectives affected. A material weakness related to an ineffective control environment is an example of this situation. If management and the auditor have difficulty in identifying *all* of the stated control objectives affected by a material weakness, the material weakness is probably not suitable for this type of narrow, interim reporting and should be tested, instead, during the auditor's annual audit of internal control over financial reporting conducted under Auditing Standard No. 2.

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[13] Several investors, among others, suggested that, in the circumstance in which additional material weaknesses were previously reported but are not the subject of the auditor's report on whether a material weakness continues to exist, the auditor's report should draw attention to these other material weaknesses. In response to these comments, the standard states that when referring to his or her previously issued report, the auditor is required either to attach that report to his or her report on whether the material weakness continues to exist or to include information about where the previously issued report can be publicly obtained.

[14] See Paragraphs 68 through 70 of Auditing Standard No. 2 for additional information on relevant assertions.

VII. Using the Work of Others

Auditing Standard No. 4 applies the same framework for using the work of others as the one described in Auditing Standard No. 2. Similar to Auditing Standard No. 2, the standard permits the auditor to use the work of others to alter the nature, timing, and extent of the auditor's performance of work related to this engagement. This framework requires the auditor to obtain the principal evidence supporting his or her opinion and to evaluate the nature of the controls being tested, together with the competence and objectivity of the persons performing the work.

Under both Auditing Standard No. 2 and this standard, the framework measures principal evidence in relation to the overall assurance provided by the auditor. Under Auditing Standard No. 2, the principal evidence supporting the auditor's opinion should be evaluated in relation to the auditor's opinion on internal control over financial reporting overall. Under this standard, the evaluation of whether the auditor has obtained the principal evidence supporting his or her opinion needs to be applied at the control objective level. It should be noted, however, that this does not require the auditor to obtain the principal evidence that each control specifically identified in management's assertion as related to the identified control objectives is effective.

There may be some circumstances in which the scope of the audit procedures to be performed in this type of engagement will be so limited that using the work of others will not provide any tangible benefit to the company or its auditor. The flexibility that the framework otherwise provides, however, is meant to encourage auditors to evaluate whether opportunities exist to use the work of others in this context.

VIII. Effective Date of the Standard

The standard will be effective as of the date of SEC approval.

* * *

On the 26th day of July, in the year 2005, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Acting Secretary
July 26, 2005

APPENDICES—

1. Auditing Standard No. 4—*Reporting on Whether a Previously Reported Material Weakness Continues to Exist*
2. Conforming Amendment to PCAOB Auditing and Related Professional Practice Standards Resulting from the Adoption of Auditing Standard No. 4—*Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

Appendix 1

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

[*Appendix omitted; see Auditing Standard No. 4 for the full text of the standard*.]

Appendix 2

Conforming Amendment to PCAOB Auditing and Related Professional Practice Standards Resulting from the Adoption of the Auditing Standard No. 4—*Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

[*Appendix omitted; see appendix 2 in PCAOB Release No. 2005-015 for a list of the amendments*.]

Auditing Standard No. 5

An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements

Source: Auditing Standard Nos. 8–15; Auditing Standard No. 16.

[Effective pursuant to SEC Release No. 34-56152; File No. PCAOB-2007-02; July 27, 2007.]

Introduction

1. This standard establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of **management's assessment**[1] of the effectiveness **of internal control over financial reporting** ("the audit of internal control over financial reporting") that is integrated with an audit of the financial statements.[2]

2. Effective internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes.[3] If one or more **material weaknesse**s exist, the company's internal control over financial reporting cannot be considered effective.[4]

3. *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company's internal control over financial reporting. Because a company's internal control cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain appropriate evidence that is sufficient to obtain reasonable assurance[5] about whether material weaknesses exist as of the date specified in management's assessment. A material weakness in internal control over financial reporting may exist even when financial statements are not materially misstated.

4. The general standards[6] are applicable to an audit of internal control over financial reporting. Those standards require technical training and proficiency as an auditor, independence, and the exercise of due professional care, including

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

[2] This auditing standard supersedes Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*, and is the standard on attestation engagements referred to in Section 404(b) of the Act. It also is the standard referred to in Section 103(a)(2)(A)(iii) of the Act.

[3] See Securities Exchange Act Rules 13a-15(f) and 15d-15(f), 17 C.F.R. §§ 240.13a-15(f) and 240.15d-15(f); Paragraph A5.

[4] See Item 308 of Regulation S-K, 17 C.F.R. § 229.308.

[5] See AU section 230, *Due Professional Care in the Performance of Work*, for further discussion of the concept of reasonable assurance in an audit.

[6] See AU section 150, *Generally Accepted Auditing Standards*.

professional skepticism. This standard establishes the fieldwork and reporting standards applicable to an audit of internal control over financial reporting.

5. 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.[7]

Integrating the Audits

6. The audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits.

7. In an integrated audit of internal control over financial reporting and the financial statements, the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously—

- To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end, and
- To obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.

8. Obtaining sufficient evidence to support control risk assessments of low for purposes of the financial statement audit ordinarily allows the auditor to reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements. (See Appendix B for additional direction on integration.)

> Note: In some circumstances, particularly in some audits of smaller and less complex companies, the auditor might choose not to assess control risk as low for purposes of the audit of the financial statements. In such circumstances, the auditor's tests of the operating effectiveness of controls would be performed principally for the purpose of supporting his or her opinion on whether the company's internal control over financial reporting is effective as of year-end. The results of the auditor's financial statement auditing procedures also should inform his or her risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Planning the Audit

9. *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor should properly plan the audit of internal control over financial reporting and properly supervise the engagement team members. When planning an integrated audit, 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—

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[7] See Securities Exchange Act Rules 13a-15(c) and 15d-15(c), 17 C.F.R. §§ 240.13a-15(c) and 240.15d-15(c). SEC rules require management to base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework (also known as control criteria) established by a body or group that followed due-process procedures, including the broad distribution of the framework for public comment. For example, the report of the Committee of Sponsoring Organizations of the Treadway Commission (known as the COSO report) provides such a framework, as does the report published by the Financial Reporting Council, Internal Control Revised Guidance for Directors on the Combined Code, October 2005 (known as the Turnbull Report).

- 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, risk, and other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee[8] 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.

Role of Risk Assessment

10. Risk assessment underlies the entire audit process described by this standard, including the determination of **significant accounts and disclosures** and **relevant assertion**s, the selection of controls to test, and the determination of the evidence necessary for a given control.

11. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention that should be devoted to that area. In addition, the risk that a company's internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error. The auditor should focus more of his or her attention on the areas of highest risk. On the other hand,

[8] 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).

it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

12. The complexity of the organization, business unit, or process, will play an important role in the auditor's risk assessment and the determination of the necessary procedures.

Scaling the Audit

13. 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 objective**s. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks. Scaling is most effective as a natural extension of the risk-based approach and applicable to the audits of all companies. Accordingly, a smaller, less complex company, or even a larger, less complex company might achieve its control objectives differently than a more complex company.[9]

Addressing the Risk of Fraud

14. When planning and performing the audit of internal control over financial reporting, the auditor should take into account the results of his or her fraud risk assessment.[10] As part of identifying and testing entity-level controls, as discussed beginning at paragraph 22, and selecting other controls to test, as discussed beginning at paragraph 39, the auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls. Controls that might address these risks include—

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

15. *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

If the auditor identifies deficiencies in controls designed to prevent or detect fraud during the audit of internal control over financial reporting, the auditor should take into account those deficiencies when developing his or her response to risks of material misstatement during the financial statement audit, as provided in paragraphs 65–69 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

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[9] The SEC Advisory Committee on Smaller Public Companies considered a company's size with respect to compliance with the internal control reporting provisions of the Act. See Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission, Final Report, at p. 5 (April 23, 2006).

[10] See Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, regarding identifying risks that may result in material misstatement due to fraud. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Using the Work of Others

16. The auditor should evaluate the extent to which he or she will use the work of others to reduce the work the auditor might otherwise perform himself or herself. AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, applies in an integrated audit of the financial statements and internal control over financial reporting.

17. For purposes of the audit of internal control, however, the auditor may use the work performed by, or receive direct assistance from, internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides evidence about the effectiveness of internal control over financial reporting. In an integrated audit of internal control over financial reporting and the financial statements, the auditor also may use this work to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of the financial statements.

18. The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work. The auditor should apply paragraphs .09–.11 of AU section 322 to assess the competence and objectivity of internal auditors. The auditor should apply the principles underlying those paragraphs to assess the competence and objectivity of persons other than internal auditors whose work the auditor plans to use.

> Note: For purposes of using the work of others, competence means the attainment and maintenance of a level of understanding and knowledge that enables that person to perform ably the tasks assigned to them, and objectivity means the ability to perform those tasks impartially and with intellectual honesty. To assess competence, the auditor should evaluate factors about the person's qualifications and ability to perform the work the auditor plans to use. To assess objectivity, the auditor should evaluate whether factors are present that either inhibit or promote a person's ability to perform with the necessary degree of objectivity the work the auditor plans to use.

> Note: The auditor should not use the work of persons who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of persons who have a low level of competence regardless of their degree of objectivity. Personnel whose core function is to serve as a testing or compliance authority at the company, such as internal auditors, normally are expected to have greater competence and objectivity in performing the type of work that will be useful to the auditor.

19. The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.

Materiality

20. 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.[11]

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[11] See Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, which provides additional explanation of materiality. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Using a Top-Down Approach

21. The auditor should use a top-down approach to the audit of internal control over financial reporting to select the controls to test. A top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal control over financial reporting. The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the **financial statements and related disclosures**. The auditor then verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion.

Note: The top-down approach describes the auditor's sequential thought process in identifying risks and the controls to test, not necessarily the order in which the auditor will perform the auditing procedures.

Identifying Entity-Level Controls

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

23. Entity-level controls vary in nature and precision—

- Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.
- Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower-level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls.
- Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.

24. Entity-level controls include—

- Controls related to the control environment;
- Controls over management override;

  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.

- The company's risk assessment process;
- Centralized processing and controls, including shared service environments;
- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;
- Controls over the period-end financial reporting process; and
- Policies that address significant business control and risk management practices.

25. *Control Environment*. Because of its importance to effective internal control over financial reporting, the auditor must evaluate the control environment at the company. As part of evaluating the control environment, the auditor should assess—

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

26. *Period-end Financial Reporting Process*. Because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements, the auditor must evaluate the period-end financial reporting process. The period-end financial reporting process includes the following—

- Procedures used to enter transaction totals into the general ledger;
- Procedures related to the selection and application of accounting policies;
- 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 and quarterly financial statements; and
- Procedures for preparing annual and quarterly financial statements and related disclosures.

Note: Because the annual period-end financial reporting process normally occurs after the "as-of" date of management's assessment, those controls usually cannot be tested until after the as-of date.

27. As part of evaluating the period-end financial reporting process, the auditor should assess—

- Inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements;
- The extent of information technology ("IT") involvement in the period-end financial reporting process;
- Who participates from management;
- The locations involved in the period-end financial reporting process;
- The types of adjusting and consolidating entries; and
- The nature and extent of the oversight of the process by management, the board of directors, and the audit committee.

Note: The auditor should obtain sufficient evidence of the effectiveness of those quarterly controls that are important to determining whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion as of the date of management's assessment. However, the auditor is not required to obtain sufficient evidence for each quarter individually.

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

28. The auditor should identify significant accounts and disclosures and their relevant assertions. Relevant assertions are those financial statement assertions that have a reasonable possibility of containing a misstatement that would cause the financial statements to be materially misstated. The financial statement assertions include[12]—

- Existence or occurrence
- Completeness
- Valuation or allocation
- Rights and obligations
- Presentation and disclosure

Note: The auditor may base his or her work on assertions that differ from those in this standard if the auditor has selected and tested controls over the pertinent risks in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated.

29. To identify significant accounts and disclosures and their relevant assertions, 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 errors or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;

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[12] See Auditing Standard No. 15, *Audit Evidence*, which provides additional information on financial statement assertions. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

- 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 or disclosure characteristics.

30. 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.

31. 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.[13]

32. The components of a potential significant account or disclosure might be subject to significantly differing risks. If so, different controls might be necessary to adequately address those risks.

33. 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. Having made those determinations, the auditor should then apply the direction in Appendix B for multiple locations scoping decisions.

Understanding Likely Sources of Misstatement

34. To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives—

- Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded;

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[13] This is because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high (see paragraph 14 of Auditing Standard No. 14, *Evaluating Auditing Results*, for further discussion about undetected misstatement) or as a means of introducing unpredictability in the procedures performed (see paragraph 61 and paragraph 5 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, for further discussion about predictability of auditing procedures). *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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

35. Because of the degree of judgment required, the auditor should either perform the procedures that achieve the objectives in paragraph 34 himself or herself or supervise the work of others who provide direct assistance to the auditor, as described in AU section 322.

36. *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor also should understand how IT affects the company's flow of transactions. The auditor should apply paragraph 29 and Appendix B of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, which discuss the effect of information technology on internal control over financial reporting and the risks to assess.

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

37. *Performing Walkthroughs*. Performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 34. 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 information technology that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

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.

Selecting Controls to Test

39. 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.

40. There might be more than one control that addresses the assessed risk of misstatement to a particular relevant assertion; conversely, one control might address the assessed risk of misstatement to more than one relevant assertion. It is neither necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective.

41. The decision as to whether a control should be selected for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of misstatement to a given relevant assertion rather than on how the control is labeled (e.g., entity-level control, transaction-level control, control activity, monitoring control, **preventive control**, **detective control**).

Testing Controls

Testing Design Effectiveness

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

> 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.

43. 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.

Testing Operating Effectiveness

44. The auditor should test the operating effectiveness of a control 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.

> Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.

45. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Relationship of Risk to the Evidence to be Obtained

46. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

Note: Although the auditor must obtain evidence about the effectiveness of controls for each relevant assertion, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to express an opinion on the company's internal control over financial reporting overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

47. Factors that affect the risk associated with a control include—

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) and assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of entity-level controls, especially controls that monitor other controls;
- The nature of the control and the frequency with which it operates;
- 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); and

  Note: A less complex company or business unit with simple business processes and centralized accounting operations might have relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the IT general controls that are important to the effective operation of those application controls.

- The complexity of the control and the significance of the judgments that must be made in connection with its operation.

Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

48. When the auditor identifies deviations from the company's controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control.

Note: Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.

49. 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 may provide sufficient evidence in relation to the risk associated with the control.

Note: Walkthroughs usually consist of a combination of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control and might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough and the results of those procedures.

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

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

51. *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The nature of the tests of effectiveness 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.

52. *Timing of Tests of Controls.* Testing controls over a greater period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Further, testing performed closer to the date of management's assessment provides more evidence than testing performed earlier in the year. The auditor should balance performing the tests of controls closer to the as-of date with the need to test controls over a sufficient period of time to obtain sufficient evidence of operating effectiveness.

53. Prior to the date specified in management's assessment, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. If the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, he or she will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment, the auditor should test the design and operating effectiveness of those superseded controls, as appropriate. (See additional direction on integration beginning at paragraph B1.)

54. *Extent of Tests of Controls.* The more extensively a control is tested, the greater the evidence obtained from that test.

55. *Roll-Forward Procedures.* When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.

56. The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors—

- The specific control tested prior to the as-of date, including the risks associated with the control and the nature of the control, and the results of those tests;
- The sufficiency of the evidence of effectiveness obtained at an interim date;
- The length of the remaining period; and
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

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

Special Considerations for Subsequent Years' Audits

57. In subsequent years' audits, the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal control over financial reporting into the decision-making process for determining the nature, timing, and extent of testing necessary. This decision-making process is described in paragraphs 46–56.

58. Factors that affect the risk associated with a control in subsequent years' audits include those in paragraph 47 and the following—

- The nature, timing, and extent of procedures performed in previous audits,
- The results of the previous years' testing of the control, and
- Whether there have been changes in the control or the process in which it operates since the previous audit.

59. After taking into account the risk factors identified in paragraphs 47 and 58, the additional information available in subsequent years' audits might permit the auditor to assess the risk as lower than in the initial year. This, in turn, might permit the auditor to reduce testing in subsequent years.

60. The auditor may also use a benchmarking strategy for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B28.

61. In addition, the auditor should vary the nature, timing, and extent of testing of controls from year to year to introduce unpredictability into the testing and respond to changes in circumstances. For this reason, each year the auditor might test controls at a different interim period, increase or reduce the number and types of tests performed, or change the combination of procedures used.

Evaluating Identified Deficiencies

62. The auditor must evaluate the severity of each control **deficiency** that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses as of the date of management's assessment. In planning and performing the audit, however, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.

63. The severity of a deficiency depends on—

- Whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure; and
- The magnitude of the potential misstatement resulting from the deficiency or deficiencies.

64. The severity of a deficiency does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement.

65. Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following—

- The nature of the financial statement accounts, disclosures, and assertions involved;
- The susceptibility of the related asset or liability to loss or fraud;
- The subjectivity, complexity, or extent of judgment required to determine the amount involved;
- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant;
- The interaction of the deficiencies; and
- The possible future consequences of the deficiency.

  Note: The evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.

  Note: Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood

of misstatement and may, in combination, constitute a material weakness, even though such deficiencies may individually be less severe. Therefore, the auditor should determine whether individual control deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a material weakness.

66. Factors that affect the magnitude of the misstatement that might result from a deficiency or deficiencies in controls include, but are not limited to, the following—

- The financial statement amounts or total of transactions exposed to the deficiency; and
- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

67. In evaluating the magnitude of the potential misstatement, the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

68. The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.

Indicators of Material Weaknesses

69. Indicators of material weaknesses in internal control over financial reporting include—

- Identification of fraud, whether or not material, on the part of senior management;[14]
- Restatement of previously issued financial statements to reflect the correction of a material misstatement;[15]
- Identification by the auditor of a material misstatement of financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal control over financial reporting; and
- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

70. When evaluating the severity of a deficiency, or combination of deficiencies, the auditor also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with

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[14] For the purpose of this indicator, the term "senior management" includes the principal executive and financial officers signing the company's certifications as required under Section 302 of the Act as well as any other members of senior management who play a significant role in the company's financial reporting process.

[15] See Financial Accounting Standards Board Statement No. 154, *Accounting Changes and Error Corrections*, regarding the correction of a misstatement.

generally accepted accounting principles. If the auditor determines that a deficiency, or combination of deficiencies, might prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles, then the auditor should treat the deficiency, or combination of deficiencies, as an indicator of a material weakness.

Wrapping-Up

Forming an Opinion

71. 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.

> Note: As part of this evaluation, the auditor should review reports issued during the year by internal audit (or similar functions) that address controls related to internal control over financial reporting and evaluate control deficiencies identified in those reports.

72. After forming an opinion on the effectiveness of the company's internal control over financial reporting, the auditor should evaluate the presentation of the elements that management is required, under the SEC's rules, to present in its annual report on internal control over financial reporting.[16]

73. If the auditor determines that any required elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should follow the direction in paragraph C2.

74. The auditor may form an opinion on the effectiveness of internal control over financial reporting only when there have been no restrictions on the scope of the auditor's work. A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement (see paragraphs C3–C7).

Obtaining Written Representations

75. In an audit of internal control over financial reporting, the auditor should obtain written representations from management—

a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;

b. Stating that management has performed an evaluation and made an assessment of the effectiveness of the company's internal control over financial reporting and specifying the control criteria;

c. Stating that management did not use the auditor's procedures performed during the audits of internal control over financial reporting or the financial statements as part of the basis for management's assessment of the effectiveness of internal control over financial reporting;

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[16] See Item 308(a) of Regulations S-B and S-K, 17 C.F.R. §§ 228.308(a) and 229.308(a).

d. Stating management's conclusion, as set forth in its assessment, about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date;

e. Stating that management has disclosed to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's evaluation, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control over financial reporting;

f. Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a material misstatement to the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting;

g. Stating whether control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraphs 78 and 80 have been resolved, and specifically identifying any that have not; and

h. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

76. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit. As discussed further in paragraph C3, when the scope of the audit is limited, the auditor should either withdraw from the engagement or disclaim an opinion. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, including those obtained in the audit of the company's financial statements.

77. AU section 333, *Management Representations*, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updated letter.

Communicating Certain Matters

78. The auditor must communicate, in writing, to management and the audit committee all material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on internal control over financial reporting.

79. If the auditor concludes that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that conclusion in writing to the board of directors.

80. *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

The auditor also should consider whether there are any deficiencies, or combinations of deficiencies, that have been identified during the audit that are **significant deficiencies** and must communicate such deficiencies, in writing,

to the audit committee. This communication should be made in a timely manner and prior to the issuance of the auditor's report on internal control over financial reporting.

81. *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

The auditor also should communicate to management, in writing, all deficiencies in internal control over financial reporting (i.e., those deficiencies in internal control over financial reporting that are of a lesser magnitude than material weaknesses) identified during the audit and inform the audit committee when such a communication has been made. The auditor should communicate this information to the audit committee in a timely manner and prior to the issuance of the auditor's report on internal control over financial reporting. When making this communication, it is not necessary for the auditor to repeat information about such deficiencies that has been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organization.

82. The auditor is not required to perform procedures that are sufficient to identify all control deficiencies; rather, the auditor communicates deficiencies in internal control over financial reporting of which he or she is aware.

83. Because the audit of internal control over financial reporting does not provide the auditor with assurance that he or she has identified all deficiencies less severe than a material weakness, the auditor should not issue a report stating that no such deficiencies were noted during the audit.

84. When auditing internal control over financial reporting, the auditor may become aware of fraud or possible illegal acts. In such circumstances, the auditor must determine his or her responsibilities under AU section 316, *Consideration of Fraud in a Financial Statement Audit*, AU section 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[17]

Reporting on Internal Control

85. The auditor's report on the audit of internal control over financial reporting must include the following elements[18]—

a. A title that includes the word *independent*;

b. A statement that management is responsible for maintaining effective internal control over financial reporting and for assessing the effectiveness of internal control over financial reporting;

c. An identification of management's report on internal control;

d. A statement that the auditor's responsibility is to express an opinion on the company's internal control over financial reporting based on his or her audit;

e. A definition of internal control over financial reporting as stated in paragraph A5;

f. A statement that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);

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[17] See 15 U.S.C. § 78j-1.

[18] See Appendix C, which provides direction on modifications to the auditor's report that are required in certain circumstances.

g. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;

h. A statement that an audit includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances;

i. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion;

j. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate;

k. The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria;

l. The manual or printed signature of the auditor's firm;

m. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

n. The date of the audit report.

Separate or Combined Reports

86. The auditor may choose to issue a combined report (i.e., one report containing both an opinion on the financial statements and an opinion on internal control over financial reporting) or separate reports on the company's financial statements and on internal control over financial reporting.

87. The following example combined report expressing an unqualified opinion on financial statements and an unqualified opinion on internal control over financial reporting illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited the accompanying balance sheets of W Company as of December 31, 20X8 and 20X7, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8. We also have audited W Company's internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).*"]. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits.

[*Scope paragraph*]

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*City and State or Country*]

[*Date*]

88. If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph to the auditor's report on the financial statements—

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), W Company's internal control over financial reporting as of December 31, 20X8, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinion*].

The auditor also should add the following paragraph to the report on internal control over financial reporting—

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

Report Date

89. *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the auditor's opinion. Because the auditor cannot audit internal control over financial reporting without also auditing the financial statements, the reports should be dated the same.

Material Weaknesses

90. Paragraphs 62–70 describe the evaluation of deficiencies. If there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor must express an adverse opinion on the company's internal control over financial reporting, unless there is a restriction on the scope of the engagement.[19]

91. When expressing an adverse opinion on internal control over financial reporting because of a material weakness, the auditor's report must include—

- The definition of a material weakness, as provided in paragraph A7.
- A statement that a material weakness has been identified and an identification of the material weakness described in management's assessment.

  Note: If the material weakness has not been included in management's assessment, the report should be modified to state that a material weakness has been identified but not included in management's assessment. Additionally, the auditor's report should include a description of the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness and its actual and potential effect on the presentation of the company's financial statements

[19] See paragraph C3 for direction when the scope of the engagement has been limited.

issued during the existence of the weakness. In this case, the auditor also should communicate in writing to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's assessment. If the material weakness has been included in management's assessment but the auditor concludes that the disclosure of the material weakness is not fairly presented in all material respects, the auditor's report should describe this conclusion as well as the information necessary to fairly describe the material weakness.

92. The auditor should determine the effect his or her adverse opinion on internal control has on his or her opinion on the financial statements. Additionally, the auditor should disclose whether his or her opinion on the financial statements was affected by the adverse opinion on internal control over financial reporting.

Note: If the auditor issues a separate report on internal control over financial reporting in this circumstance, the disclosure required by this paragraph may be combined with the report language described in paragraphs 88 and 91. The auditor may present the combined language either as a separate paragraph or as part of the paragraph that identifies the material weakness.

Subsequent Events

93. Changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting might occur subsequent to the date as of which internal control over financial reporting is being audited but before the date of the auditor's report. The auditor should inquire of management whether there were any such changes or factors and obtain written representations from management relating to such matters, as described in paragraph 75*h*.

94. To obtain additional information about whether changes have occurred that might affect the effectiveness of the company's internal control over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following—

- Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period,
- Independent auditor reports (if other than the auditor's) of deficiencies in internal control,
- Regulatory agency reports on the company's internal control over financial reporting, and
- Information about the effectiveness of the company's internal control over financial reporting obtained through other engagements.

95. The auditor might inquire about and examine other documents for the subsequent period. Paragraphs .01–.09 of AU section 560, *Subsequent Events*, provide direction on subsequent events for a financial statement audit that also may be helpful to the auditor performing an audit of internal control over financial reporting.

96. If the auditor obtains knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal control over financial reporting as of the date specified in the assessment, the auditor should issue an adverse opinion on internal control over financial reporting (and follow the direction in paragraph C2 if management's assessment states that internal

control over financial reporting is effective). If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the company's internal control over financial reporting, the auditor should disclaim an opinion. As described in paragraph C13, the auditor should disclaim an opinion on management's disclosures about corrective actions taken by the company after the date of management's assessment, if any.

97. The auditor may obtain knowledge about subsequent events with respect to conditions that did not exist at the date specified in the assessment but arose subsequent to that date and before issuance of the auditor's report. If a subsequent event of this type has a material effect on the company's internal control over financial reporting, the auditor should include in his or her report an explanatory paragraph describing the event and its effects or directing the reader's attention to the event and its effects as disclosed in management's report.

98. After the issuance of the report on internal control over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had he or she been aware of them. The auditor's evaluation of such subsequent information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

Appendix A

Definitions

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

A2. A **control objective** provides a specific target against which to evaluate the effectiveness of controls. A control objective for internal control over financial reporting generally relates to a relevant assertion and states a criterion for evaluating whether the company's control procedures in a specific area provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented or detected by controls on a timely basis.

A3. A **deficiency** in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in *design* exists when (*a*) a control necessary to meet the control objective is missing or (*b*) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.
- A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

A4. **Financial statements and related disclosures** refers to a company's financial statements and notes to the financial statements as presented in accordance with generally accepted accounting principles ("GAAP"). References to financial statements and related disclosures do not extend to the preparation of management's discussion and analysis or other similar financial information presented outside a company's GAAP-basis financial statements and notes.

A5. **Internal control over financial reporting** is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that—

(1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.[1]

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[1] See Securities Exchange Act Rules 13a-15(f) and 15d-15(f), 17 C.F.R. §§ 240.13a-15(f) and 240.15d-15(f).

Note: The auditor's procedures as part of either the audit of internal control over financial reporting or the audit of the financial statements are not part of a company's internal control over financial reporting.

Note: Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

A6. **Management's assessment** is the assessment described in Item 308(a)(3) of Regulations S-B and S-K that is included in management's annual report on internal control over financial reporting.[2]

A7. A **material weakness** is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a **reasonable possibility** that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Note: 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 Financial Accounting Standards Board Statement No. 5, Accounting for Contingencies ("FAS 5").[3]

A8. Controls over financial reporting may be **preventive controls** or **detective controls**. Effective internal control over financial reporting often includes a combination of preventive and detective controls.

- Preventive controls have the objective of preventing errors or fraud that could result in a misstatement of the financial statements from occurring.
- Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements.

A9. 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.

A10. 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.

A11. A **significant deficiency** is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

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[2] See 17 C.F.R. §§ 228.308(a)(3) and 229.308(a)(3).

[3] See FAS 5, paragraph 3.

Appendix B

Special Topics

Integration of Audits

B1. *Tests of Controls in an Audit of Internal Control.* The objective of the tests of controls in an audit of internal control over financial reporting 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*.

B2. To express an opinion on internal control over financial reporting as of a point in time, the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To express an opinion on internal control over financial reporting taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant assertions. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

B3. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on internal control over financial reporting, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements, as discussed in the following section.

B4. *Tests of Controls in an Audit of Financial Statements.* To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* upon which the auditor plans to place reliance on those controls. 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.

B5. When concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the company's internal control over financial reporting, as discussed in paragraph B2. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.

B6. *Effect of Tests of Controls on Substantive Procedures.* If, during the audit of internal control over financial reporting, the auditor identifies a deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.

B7. Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements,

the auditor should perform substantive procedures for all relevant assertions. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.

B8. *Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls*. In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, at a minimum—

- The auditor's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.
- Findings with respect to illegal acts and related party transactions.
- Indications of management bias in making accounting estimates and in selecting accounting principles.
- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

B9. To obtain evidence about whether a selected 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. The absence of misstatements detected by substantive procedures, however, should inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Multiple Locations Scoping Decisions

B10. In determining the locations or business units at which to perform tests of controls, the auditor should assess the risk of material misstatement to the 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.

> Note: The auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the company's consolidated financial statements.

B11. In assessing and responding to risk, the auditor should test controls over specific risks that present a reasonable possibility of material misstatement to the company's consolidated financial statements. In lower-risk locations or business units, the auditor first might evaluate whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides the auditor with sufficient evidence.

B12. In determining the locations or business units at which to perform tests of controls, the auditor may take into account work performed by others on behalf of management. For example, if the internal auditors' planned procedures include relevant audit work at various locations, the auditor may coordinate work with the internal auditors and reduce the number of locations or business units at which the auditor would otherwise need to perform auditing procedures.

B13. The direction in paragraph 61 regarding special considerations for subsequent years' audits means that the auditor should vary the nature, timing, and extent of testing of controls at locations or business units from year to year.

B14. *Special Situations*. The scope of the audit should include entities that are acquired on or before the date of management's assessment and operations that are accounted for as discontinued operations on the date of management's assessment. The direction in this multiple-locations discussion describes how to determine whether it is necessary to test controls at these entities or operations.

B15. For equity method investments, the scope of the audit should include controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The audit ordinarily would not extend to controls at the equity method investee.

B16. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. In these situations, the auditor's opinion would not be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the scope paragraph in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities that are described in paragraphs .29–.32 of AU section 722, *Interim Financial Information*. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure requires modification.

Use of Service Organizations

B17. AU section 324, *Service Organizations*, applies to the audit of financial statements of a company that obtains services from another organization that are part of the company's information system. The auditor may apply the relevant concepts described in AU section 324 to the audit of internal control over financial reporting.

B18. AU section 324.03 describes the situation in which a service organization's services are part of a company's information system. If the service organization's services are part of a company's information system, as described therein, then they are part of the information and communication component of the company's internal control over financial reporting. When the service organization's services are part of the company's internal control over financial reporting, the auditor should include the activities of the service organization when determining the evidence required to support his or her opinion.

B19. AU section 324.07–.16 describe the procedures that the auditor should perform with respect to the activities performed by the service organization. The procedures include—

a. Obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization, and

b. Obtaining evidence that the controls that are relevant to the auditor's opinion are operating effectively.

B20. Evidence that the controls that are relevant to the auditor's opinion are operating effectively may be obtained by following the procedures described in AU section 324.12. These procedures include—

a. Obtaining a service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.

Note: The service auditor's report referred to above means a report with the service auditor's opinion on the service organization's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period (in other words, "reports on controls placed in operation and tests of operating effectiveness" described in AU section 324.24*b*). A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness (in other words, "reports on controls placed in operation" described in AU section 324.24*a*) does not provide evidence of operating effectiveness. Furthermore, if the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report issued pursuant to AU section 324, the auditor should evaluate whether the agreed-upon procedures report provides sufficient evidence in the same manner described in the following paragraph.

b. Performing tests of the user organization's controls over the activities of the service organization (e.g., testing the user organization's independent re-performance of selected items processed by the service organization or testing the user organization's reconciliation of output reports with source documents).

c. Performing tests of controls at the service organization.

B21. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, the auditor may evaluate whether this report provides sufficient evidence to support his or her opinion. In evaluating whether such a service auditor's report provides sufficient evidence, the auditor should assess the following factors—

- The time period covered by the tests of controls and its relation to the as-of date of management's assessment,
- The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the company's controls, and
- The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

Note: These factors are similar to factors the auditor would consider in determining whether the report provides sufficient evidence to support the auditor's assessed level of control risk in an audit of the financial statements, as described in AU section 324.16.

B22. If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the company applies controls contemplated in

the design of the system by the service organization, the auditor should evaluate whether the company is applying the necessary procedures.

B23. In determining whether the service auditor's report provides sufficient evidence to support the auditor's opinion, the auditor should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in paragraph .10*a* of AU section 543, *Part of Audit Performed by Other Independent Auditors*.

B24. When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the company's internal control over financial reporting. The auditor also should evaluate whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization.

B25. The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following risk factors. As risk increases, the need for the auditor to obtain additional evidence increases.

- The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment,
- The significance of the activities of the service organization,
- Whether there are errors that have been identified in the service organization's processing, and
- The nature and significance of any changes in the service organization's controls identified by management or the auditor.

B26. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures might include—

- Evaluating procedures performed by management and the results of those procedures.
- Contacting the service organization, through the user organization, to obtain specific information.
- Requesting that a service auditor be engaged to perform procedures that will supply the necessary information.
- Visiting the service organization and performing such procedures.

B27. The auditor should not refer to the service auditor's report when expressing an opinion on internal control over financial reporting.

Benchmarking of Automated Controls

B28. Entirely automated application controls are generally not subject to breakdowns due to human failure. This feature allows the auditor to use a "benchmarking" strategy.

B29. If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor established a baseline (i.e., last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor should obtain to verify that the control has not changed may vary depending on the circumstances, including depending on the strength of the company's program change controls.

B30. The consistent and effective functioning of the automated application controls may be dependent upon the related files, tables, data, and parameters. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

B31. To determine whether to use a benchmarking strategy, the auditor should assess the following risk factors. As these factors indicate lower risk, the control being evaluated might be well-suited for benchmarking. As these factors indicate increased risk, the control being evaluated is less suited for benchmarking. These factors are—

- The extent to which the application control can be matched to a defined program within an application.
- The extent to which the application is stable (i.e., there are few changes from period to period).
- The availability and reliability of a report of the compilation dates of the programs placed in production. (This information may be used as evidence that controls within the program have not changed.)

B32. Benchmarking automated application controls can be especially effective for companies using purchased software when the possibility of program changes is remote—e.g., when the vendor does not allow access or modification to the source code.

B33. After a period of time, the length of which depends upon the circumstances, the baseline of the operation of an automated application control should be reestablished. To determine when to reestablish a baseline, the auditor should evaluate the following factors—

- The effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls and computer operations.
- The auditor's understanding of the nature of changes, if any, on the specific programs that contain the controls.
- The nature and timing of other related tests.
- The consequences of errors associated with the application control that was benchmarked.

- Whether the control is sensitive to other business factors that may have changed. For example, an automated control may have been designed with the assumption that only positive amounts will exist in a file. Such a control would no longer be effective if negative amounts (credits) begin to be posted to the account.

Appendix C

Special Reporting Situations

Report Modifications

C1. The auditor should modify his or her report if any of the following conditions exist.

a. Elements of management's annual report on internal control are incomplete or improperly presented,

b. There is a restriction on the scope of the engagement,

c. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report,

d. There is other information contained in management's annual report on internal control over financial reporting, or

e. Management's annual certification pursuant to Section 302 of the Sarbanes-Oxley Act is misstated.

C2. *Elements of Management's Annual Report on Internal Control Over Financial Reporting Are Incomplete or Improperly Presented*. If the auditor determines that elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should modify his or her report to include an explanatory paragraph describing the reasons for this determination. If the auditor determines that the required disclosure about a material weakness is not fairly presented in all material respects, the auditor should follow the direction in paragraph 91.

C3. *Scope Limitations*. The auditor can express an opinion on the company's internal control over financial reporting only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement, the auditor should withdraw from the engagement or disclaim an opinion. A disclaimer of opinion states that the auditor does not express an opinion on the effectiveness of internal control over financial reporting.

C4. When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the audit was not sufficient to warrant the expression of an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of internal control over financial reporting (paragraph 85 *g*, *h*, and *i*); to do so might overshadow the disclaimer.

C5. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that a material weakness exists, the auditor's report also should include—

- The definition of a material weakness, as provided in paragraph A7.
- A description of any material weaknesses identified in the company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address the requirements in paragraph 91.

C6. The auditor may issue a report disclaiming an opinion on internal control over financial reporting as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. The auditor is not required to perform any additional work prior to issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

[The following note is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]

> Note: In this case, in following the direction in paragraph 89 regarding dating the auditor's report, the report date is the date that the auditor has obtained sufficient appropriate evidence to support the representations in the auditor's report.

C7. If the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the audit, the auditor should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed.

C8. *Opinions Based, in Part, on the Report of Another Auditor*. When another auditor has audited the financial statements and internal control over financial reporting of one or more subsidiaries, divisions, branches, or components of the company, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinion. AU section 543, *Part of Audit Performed by Other Independent Auditors*, provides direction on the auditor's decision of whether to serve as the principal auditor of the financial statements. If the auditor decides it is appropriate to serve as the principal auditor of the financial statements, then that auditor also should be the principal auditor of the company's internal control over financial reporting. This relationship results from the requirement that an audit of the financial statements must be performed to audit internal control over financial reporting; only the principal auditor of the financial statements can be the principal auditor of internal control over financial reporting. In this circumstance, the principal auditor of the financial statements must participate sufficiently in the audit of internal control over financial reporting to provide a basis for serving as the principal auditor of internal control over financial reporting.

C9. When serving as the principal auditor of internal control over financial reporting, the auditor should decide whether to make reference in the report on internal control over financial reporting to the audit of internal control over financial reporting performed by the other auditor. In these circumstances, the auditor's decision is based on factors analogous to those of the auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements as described in AU section 543.

C10. The decision about whether to make reference to another auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment performed by another independent auditor, but the report on internal control over financial reporting might not make a similar reference because management's assessment of internal control over financial reporting ordinarily would not extend to controls at the equity method investee.[1]

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[1] See paragraph B15, for further discussion of the evaluation of the controls over financial reporting for an equity method investment.

C11. When the auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinion on the company's internal control over financial reporting, the auditor should refer to the report of the other auditor when describing the scope of the audit and when expressing the opinion.

C12. *Management's Annual Report on Internal Control Over Financial Reporting Containing Additional Information*. Management's annual report on internal control over financial reporting may contain information in addition to the elements described in paragraph 72 that are subject to the auditor's evaluation.

C13. If management's annual report on internal control over financial reporting could reasonably be viewed by users of the report as including such additional information, the auditor should disclaim an opinion on the information.

C14. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information. AU section 317, *Illegal Acts by Clients* and Section 10A of the Securities Exchange Act of 1934 may also require the auditor to take additional action.[2]

> Note: If management makes the types of disclosures described in paragraph C12 outside its annual report on internal control over financial reporting and includes them elsewhere within its annual report on the company's financial statements, the auditor would not need to disclaim an opinion. However, in that situation, the auditor's responsibilities are the same as those described in this paragraph if the auditor believes that the additional information contains a material misstatement of fact.

C15. *Management's Annual Certification Pursuant to Section 302 of the Sarbanes-Oxley Act is Misstated*. If matters come to the auditor's attention as a result of the audit of internal control over financial reporting that lead him or her to believe that modifications to the disclosures about changes in internal control over financial reporting (addressing changes in internal control over financial reporting occurring during the fourth quarter) are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[3] the auditor should follow the communication responsibilities as described in AU section 722*, Interim Financial Information*, for any interim period. However, if management and the audit committee do not respond appropriately, in addition to the responsibilities described in AU section 722, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons the auditor believes management's disclosures should be modified.

Filings Under Federal Securities Statutes

C16. AU section 711, *Filings Under Federal Securities Statutes*, describes the auditor's responsibilities when an auditor's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes. The auditor should apply AU section 711 with respect to the

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[2] See 15 U.S.C. § 78j-1.

[3] See 17 C.F.R. §§ 240.13a-14(a) and 240.15d-14(a).

auditor's report on internal control over financial reporting included in such filings. In addition, the auditor should extend the direction in AU section 711.10 to inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters about whether any events have occurred that have a material effect on the audited financial statements to matters that could have a material effect on internal control over financial reporting.

C17. When the auditor has fulfilled these responsibilities and intends to consent to the inclusion of his or her report on internal control over financial reporting in the securities filing, the auditor's consent should clearly indicate that both the audit report on financial statements and the audit report on internal control over financial reporting (or both opinions if a combined report is issued) are included in his or her consent.

Attachment

PCAOB Release No. 2007-005A

June 12, 2007
PCAOB Rulemaking
Docket Matter No. 021

Summary

After public comment, the Public Company Accounting Oversight Board is adopting Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, as well as an independence rule and conforming amendments to the Board's auditing standards.

Board Contact

Sharon Virag, Associate Chief Auditor (202/207-9164)

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1. Introduction

In 2002, Congress passed the Sarbanes-Oxley Act (the "Act"), which, among other things, established new provisions related to internal control over financial reporting. Section 404 of the Act requires company management to assess and report on the effectiveness of the company's internal control. It also requires a company's independent auditor, registered with the Public Company Accounting Oversight Board ("PCAOB" or "Board"), to attest to management's disclosures regarding the effectiveness of its internal control. As directed by Sections 103 and 404 of the Act, the Board established a standard to govern the newly required audit by adopting Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("Auditing Standard No. 2").[1] The Securities and Exchange Commission ("Commission" or "SEC") approved Auditing Standard No. 2 on June 17, 2004.[2]

Since Auditing Standard No. 2 became effective, the Board has closely monitored the progress registered firms have made in implementing its requirements. The PCAOB's monitoring has included gathering information during inspections of registered public accounting firms; participating, along with the SEC, in two roundtable discussions with representatives of issuers, auditors, investor groups, and others; meeting with its Standing Advisory Group; receiving feedback from participants in the Board's Forums on Auditing in the Small Business Environment; and reviewing academic, government, and other reports and studies.

As a result of this monitoring, two basic propositions emerged.[3] First, the audit of internal control over financial reporting has produced significant benefits,

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[1] See PCAOB Release No. 2004-001 (March 9, 2004).

[2] See Securities Exchange Act Release No. 49884 (June 17, 2004).

[3] See Proposed Auditing Standard: *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Other Proposals*, PCAOB Release No. 2006-007 (Dec. 19, 2006).

including an enhanced focus on corporate governance and controls and higher quality financial reporting. Second, these benefits have come at a significant cost. Costs have been greater than expected and, at times, the related effort has appeared greater than necessary to conduct an effective audit of internal control over financial reporting.

As part of a four-point plan to improve implementation of the internal control requirements, the Board determined to amend Auditing Standard No. 2.[4] On December 19, 2006, the Board proposed for comment a new standard on auditing internal control, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that would replace Auditing Standard No. 2. The Board also proposed a related auditing standard, *Considering and Using the Work of Others in an Audit*, an independence rule relating to the auditor's provision of internal control-related non-audit services, and conforming amendments to its auditing standards.[5]

The Board issued these proposals with the primary objectives of focusing auditors on the most important matters in the audit of internal control over financial reporting and eliminating procedures that the Board believes are unnecessary to an effective audit of internal control. The proposals were designed to both increase the likelihood that material weaknesses in companies' internal control will be found before they cause material misstatement of the financial statements and steer the auditor away from procedures that are not necessary to achieve the intended benefits. The Board also sought to make the internal control audit more clearly scalable for smaller and less complex public companies and to make the text of the standard easier to understand. In formulating these proposals, the Board re-evaluated every significant aspect of Auditing Standard No. 2.

The Board received 175 comment letters on its proposals. The Board also discussed the proposals with its Standing Advisory Group on February 22, 2007.[6] A large majority of commenters were generally supportive of the Board's proposals, particularly the top-down, risk-based approach and focus on the most important matters. Based on the comments received, the Board believes that the proposal achieves, in large part, the objectives the Board set out when deciding to amend Auditing Standard No. 2. Many commenters also offered suggestions to improve the final standard, which the Board has carefully analyzed.

In considering the comments received and formulating a final standard, the Board closely coordinated its work with the SEC, which proposed guidance for management on evaluating internal control at the same time that the Board issued its proposals.[7] In addition to its role in implementing Section 404(a) of the Act, the SEC must approve new PCAOB auditing standards before they can become effective.[8] On April 4, 2007, the Commission held a public meeting to discuss the Board's proposals and the coordination of those proposals with the

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[4] See PCAOB Press Release, "Board Announces Four-Point Plan to Improve Implementation of Internal Control Reporting Requirements" (May 17, 2006). The other aspects of the plan are: (1) reinforcing auditor efficiency through PCAOB inspections; (2) developing or facilitating development of implementation guidance for auditors of smaller public companies; and (3) continuing PCAOB Forums on Auditing in the Small Business Environment.

[5] Proposed Auditing Standard: *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Other Proposals*, PCAOB Release No. 2006-007 (Dec. 19, 2006).

[6] A transcript of the portion of the meeting that related to the proposals and an archived web cast of the entire meeting are available on the Board's Web site at http://pcaobus.org/News/Events/Documents/02222007_SAGMeeting/SAG_Transcript.pdf.

[7] See Securities Exchange Act Release No. 54976 (Dec. 20, 2006).

[8] See Section 107 of the Act.

Commission's proposed management guidance. At the meeting, the SEC staff provided the Commission its analysis of the public comments on the PCAOB's proposal and the proposed management guidance. The Commission endorsed the recommendations of its staff and directed its staff to focus its remaining work in four areas:

- "Aligning the PCAOB's new auditing standard ... with the SEC's proposed new management guidance under Section 404, particularly with regard to prescriptive requirements, definitions, and terms";
- "Scaling the 404 audit to account for the particular facts and circumstances of companies, particularly smaller companies";
- "Encouraging auditors to use professional judgment in the 404 process, particularly in using risk-assessment"; and
- "Following a principles-based approach to determining when and to what extent the auditor can use the work of others."[9]

After careful consideration of the comments it received and the input from the SEC, the Board has refined its proposals to provide additional clarity and further help auditors to focus on the most important matters. The Board has decided to adopt the revised standard on auditing internal control as 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"), to supersede Auditing Standard No. 2. The Board has also decided to adopt the independence rule and conforming amendments to the auditing standards.[10]

2. Notable Areas of Change in the Final Standard

As stated above, the Board believes that the changes made to the proposal reflect refinements, rather than significant shifts in approach. This section describes the areas of change to the proposals that are most notable. Appendix 4 contains additional discussion of comments received on the proposals and the Board's response.

A. Alignment with management guidance

On December 20, 2006, the SEC issued proposed guidance to help management evaluate internal control for purposes of its annual assessment. In formulating a new standard on auditing internal control, the Board sought to describe an audit process that would be coordinated with management's evaluation process. Many commenters suggested, however, that the SEC's management guidance and the Board's standard should be more closely aligned.

After considering the comments in this area, the Board has decided to make changes that will improve the coordination between the SEC's management guidance and the Board's standard. In doing so, the Board has been mindful of the inherent differences in the roles of management and the auditor. Management's daily involvement with its internal control system provides it with knowledge and information that may influence its judgments about how best to evaluate internal control and the sufficiency of the evidence it needs for its

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[9] See SEC Press Release, "SEC Commissioners Endorse Improved Sarbanes-Oxley Implementation To Ease Smaller Company Burdens, Focusing Effort On 'What Truly Matters'" (Apr. 4, 2007).

[10] As discussed below, the Board has determined not to adopt the proposed auditing standard on considering and using the work of others.

annual assessment. Management also should be able to rely on self-assessment and, more generally, the monitoring component of internal control, provided the monitoring component is properly designed and operates effectively.

The auditor is required to provide an independent opinion on the effectiveness of the company's internal control over financial reporting. The auditor does not have the familiarity with the company's controls that management has and does not interact with or observe these controls with the same frequency as management. Therefore, the auditor cannot obtain sufficient evidence to support an opinion on the effectiveness of internal control based solely on observation of or interaction with the company's controls. Rather, the auditor needs to perform procedures such as inquiry, observation, and inspection of documents, or walkthroughs, which consist of a combination of those procedures, in order to fully understand and identify the likely sources of potential misstatements, while management might be aware of those risk areas on an on-going basis.

The Board believes, however, that the general concepts necessary to an understanding of internal control should be described in the same way in the Board's standard and in the SEC's guidance. Accordingly, the Board has decided to use the same definition of material weakness in its standard that the SEC uses in its final management guidance and related rules. In addition, the Board is adopting the definition of significant deficiencies that the SEC has proposed. The final standard and final management guidance also describe the same indicators of a material weakness. In addition, as described more fully below, the final standard on auditing internal control uses the term "entity-level controls" instead of "company-level controls," which was used in the proposed standard, in order to use the same term as the SEC uses in its final management guidance.[11] Auditing Standard No. 5's discussion of the effect of these controls is also consistent with the discussion of the same topic in the SEC's final guidance.

B. The top-down approach

The proposed standard on auditing internal control was structured around the top-down approach to identifying the most important controls to test. This approach follows the same principles that apply to the financial statement audit—the auditor determines the areas of focus through the identification of significant accounts and disclosures and relevant assertions. Under the proposed standard, the auditor would specifically identify major classes of transactions and significant processes before identifying the controls to test.

In response to comments about the level of detail in the requirements of the proposed standard, the Board has reconsidered whether the final standard should include the identification of major classes of transactions and significant processes as a specifically required step in the top-down approach. As a practical matter, the auditor will generally need to understand the company's processes to appropriately identify the correct controls to test. The Board believes, however, that specific requirements directing the auditor how to obtain that understanding are unnecessary and could contribute to a "checklist approach" to compliance, particularly for auditors who have a long-standing familiarity with the company. Accordingly, the Board has removed the requirements to identify major classes of transactions and significant processes from the final standard. While this should allow auditors to apply more professional judgment as they work through the top-down approach, the end point is the same as in

[11] These terms were used interchangeably in the proposed standard and SEC's proposed management guidance and, for these purposes, they mean the same thing. See Securities Exchange Act Release No. 54976 (Dec. 20, 2006), at 12 fn. 29.

the proposed standard—the requirement to test those controls that address the assessed risk of misstatement to each relevant assertion.[12]

C. Emphasis on fraud controls

The proposed standard on auditing internal control discussed fraud controls and the auditor's procedures related to these controls among the testing concepts included near the end of the standard. Commenters suggested that the placement of the discussion, or the lack of specificity regarding the controls that should be deemed fraud controls, failed to properly emphasize these controls or provide auditors with sufficient direction on how to test fraud controls. In response, the Board has made several changes in the final standard.

First, the discussion of fraud risk and anti-fraud controls has been moved closer to the beginning of the standard to emphasize to auditors the relative importance of these matters in assessing risk throughout the top-down approach.[13] Incorporating the auditor's fraud risk assessment—required in the financial statement audit—into the auditor's planning process for the audit of internal control should promote audit quality as well as better integration. While internal control cannot provide absolute assurance that fraud will be prevented or detected, these controls should help to reduce instances of fraud, and, therefore, a concerted focus on fraud controls in the internal control audit should enhance investor protection. Second, management fraud has also been identified in the final standard as an area of higher risk; accordingly, the auditor should focus more of his or her attention on this area.[14] Finally, the standard, as adopted, provides additional guidance on the types of controls that might address fraud risk.[15]

D. Entity-level controls

The proposed standard on auditing internal control emphasized entity-level controls because of their importance both to the auditor's ability to appropriately tailor the audit through a top-down approach—specifically by identifying and testing the most important controls—and to effective internal control. Additionally, the proposed standard emphasized that these controls might, depending on the circumstances, allow the auditor to reduce the testing of controls at the process level. Commenters suggested that the proposed standard did not provide enough direction on how entity-level controls can significantly reduce testing, and some suggested that controls that operate at the level of precision necessary to do so are uncommon. Many commenters suggested incorporating in the final standard the discussion of direct versus indirect entity-level controls that was included in the SEC's proposed management guidance.

The Board continues to believe that entity-level controls, depending on how they are designed and operate, can reduce the testing of other controls related to a relevant assertion. This is either because the entity-level control sufficiently addresses the risk related to the relevant assertion, or because the entity-level controls provide some assurance so that the testing of other controls related to that assertion can be reduced. In response to comments and in order to clarify these concepts, the Board included in the final standard a discussion of three broad categories of entity-level controls, which vary in nature and precision,

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[12] See paragraph 21.

[13] See paragraphs 14 and 15.

[14] See paragraph 11.

[15] See paragraph 14.

along with an explanation of how each category might have a different effect on the performance of tests of other controls.[16]

The final standard explains that some controls, such as certain control environment controls, have an important, but indirect effect, on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.

The final standard explains that other entity-level controls may not operate at the level of precision necessary to eliminate the need for testing of other controls, but can reduce the required level of testing of other controls, sometimes substantially. This is because the auditor obtains some of the supporting evidence related to a control from an entity-level control and the remaining necessary evidence from the testing of the control at the process level. Controls that monitor the operation of other controls are the best example of these types of controls. These monitoring controls help provide assurance that the controls that address a particular risk are effective and, therefore, they can provide some evidence about the effectiveness of those lower-level controls, reducing the testing of those controls that otherwise would be necessary.

Lastly, the final standard explains that some entity-level controls might operate at a level of precision that, without the need for other controls, sufficiently addresses the risk of misstatement to a relevant assertion. If a control sufficiently addresses the risk in this manner, the auditor does not need to test other controls related to that risk.

E. Walkthroughs

The proposed standard on auditing internal control would have required auditors to perform a walkthrough of each significant process each year. This proposed requirement represented a change from Auditing Standard No. 2, which required a walkthrough of each major class of transactions within a significant process. Commenters were split on the question of whether the re-calibration from major class of transactions to significant process in the proposed standard would result in a reduction of effort. Some issuers and auditors suggested that walkthroughs are already being performed on significant processes, while other issuers and auditors commented that this proposed requirement would make a difference. A few commenters suggested that a walkthrough of each significant process was insufficient and would negatively affect audit quality, but many others stated that walkthroughs should not be required at all.

In evaluating these comments, the Board focused principally on the objectives it believes are achieved through a properly performed walkthrough. The Board firmly believes that those objectives should be met for the auditor to verify that he or she has a sufficient understanding of the points within the processes where misstatements could occur and to properly identify the controls to test.[17] Procedures that fulfill those objectives also play an important role in the evaluation of the effectiveness of the design of the controls. The Board believes that, in some instances, the requirement to perform a walkthrough may have overshadowed the objectives it was meant to achieve. This may have resulted in some walkthroughs being performed to meet the requirement but failing to achieve the intended purpose. The final standard, therefore, focuses specifically

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[16] See paragraph 23. The Board believes that expertise of auditors and companies in the area of entity-level controls will continue to evolve. For example, the Committee of Sponsoring Organizations of the Treadway Commission has begun a project on the monitoring component of internal control that may provide some guidance in this area.

[17] See paragraph 34, which describes these objectives.

on achieving certain important objectives, and the performance requirement is based on fulfilling those objectives as they relate to the understanding of likely sources of misstatement and the selection of controls to test.[18] While a walkthrough will frequently be the best way of attaining these goals, the auditor's focus should be on the objectives, not on the mechanics of the walkthrough. In some cases, other procedures may be equally or more effective means of achieving them.

F. Evaluation and communication of deficiencies

The proposed standard on auditing internal control required the auditor to evaluate the severity of identified control deficiencies to determine whether they are significant deficiencies or material weaknesses. It then required the auditor to communicate, in writing, to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. The proposed standard defined "significant deficiency" as "a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected." The term "significant misstatement" was defined, in turn, to mean "a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

Commenters generally supported the proposed definition of the term "significant misstatement," though some were concerned that it was too subjective. Other commenters questioned whether the standard should include a definition of significant deficiency and a requirement to communicate significant deficiencies to the audit committee. At least one commenter suggested that the term be removed from the standard.

After considering these comments, the Board has determined to make changes to the definition of significant deficiency and related requirements.[19] The Board continues to believe that the standard should require auditors to provide relevant information about important control deficiencies—even those less severe than a material weakness—to management and to the audit committee. The final standard, therefore, requires the auditor to consider and communicate any identified significant deficiencies to the audit committee. In order to emphasize that the auditor need not scope the audit to identify all significant deficiencies, however, the Board placed these provisions in the section of the final standard that describes communications requirements.[20]

The relatively minor changes that the Board made to the definition of significant deficiency are also intended to focus the auditor on the communication requirement and away from scoping issues. The final definition is based on the proposed definition of "significant misstatement," which commenters generally

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[18] See paragraph 34.

[19] The Board also made minor changes to the definition of material weakness in order to use the same definition in the SEC's management guidance and related rule. In the final standard, material weakness is defined as "a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."

[20] See paragraph 80. The final standard also includes the proposed requirement for the auditor to communicate, in writing, to management, all deficiencies in internal control identified during the audit and inform the audit committee when such a communication has been made, and the proposed requirement to inform, when applicable, the board of directors of the auditor's conclusion that the audit committee's oversight is ineffective. See paragraphs 79 and 81. Some commenters believed that the requirement to communicate all identified deficiencies to management would result in an unnecessary administrative exercise. The Board continues to believe, however, that auditors should provide information about identified control deficiencies to management.

supported, and is aligned with the SEC's proposed definition of the same term. Under the final standard, a significant deficiency is "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

G. Scaling the audit

The proposed standard on auditing internal control indicated that a company's size and complexity are important considerations and that the procedures an auditor should perform depend upon where along the size and complexity continuum a company falls. The proposed standard included a section on scaling the audit for smaller, less complex companies and would have required auditors to evaluate and document the effect of the company's size and complexity on the audit. This documentation requirement applied to audits of companies of all sizes. The proposed standard also included a list of the attributes of smaller, less complex companies and a description of how the auditor might tailor his or her procedures when these attributes are present. In general, commenters were supportive of the proposed standard's general approach to scalability, but had several recommendations for change.

Some commenters suggested that scalability should not be covered as a standalone discussion applicable only to smaller companies and that other companies, regardless of size, might have areas that are less complex. The Board agrees that the direction on scaling will be most effective if it is a natural extension of the risk-based approach and applicable to all companies. Consequently, the Board shortened the separate section on "scaling the audit," and incorporated a discussion of scaling concepts, similar to what was proposed, throughout the final standard. Specifically, notes to relevant paragraphs describe how to tailor the audit to the particular circumstances of a smaller, less complex company or unit. The Board also retained the list of attributes of smaller, less complex companies and acknowledged that, even within larger companies, some business units or processes may be less complex than others. Discussion of these attributes has been incorporated in the section on the auditor's planning procedures in the final standard.[21] As described in the proposing release, the provisions on scalability in the final standard will form the basis for guidance on auditing internal control in smaller companies to be issued this year.

Several commenters, mostly auditors, suggested that the performance requirements that applied to all companies, including large, complex companies, would lead to unnecessary and costly documentation requirements. These commenters were particularly concerned about the requirement to document the effects of size and complexity on all aspects of the audit, even if a particular engagement could not be tailored as a result of these factors. After considering these comments, the Board agreed that this documentation requirement is not necessary to promote audit quality and, therefore, has not included it in the final standard.

H. Use of the work of others in an integrated audit

At the time the Board proposed Auditing Standard No. 5 for public comment, the Board also proposed an auditing standard entitled Considering and Using the Work of Others in an Audit that would have superseded the Board's interim standard AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* ("AU sec. 322"), and replaced the direction on using the work of others in an audit of internal control in Auditing

[21] See paragraph 9.

Standard No. 2. As discussed in the proposing release, the Board had several objectives in proposing this standard. The first was to better integrate the financial statement audit and the audit of internal control by having only one framework for using the work of others in both audits. Additionally, the Board wanted to encourage auditors to use the work of others to a greater extent when the work is performed by sufficiently competent and objective persons. Among other things, under the proposed standard, auditors would have been able to use the work of sufficiently competent and objective company personnel—not just internal auditors—and third parties working under the direction of management or the audit committee for purposes of the financial statement audit as well as the audit of internal control.

The Board received numerous comments on the proposed standard on using the work of others. Commenters generally indicated support for a single framework regarding the auditor's use of the work of others in an integrated audit. Some, however, suggested retaining existing AU sec. 322 as the basis for that single framework. They expressed the view that the objective of removing barriers to integration and using the work of others to the fullest extent appropriate could be achieved by retaining AU sec. 322 and going forward with the proposed removal of the "principal evidence" provision. At the same time, some other commenters suggested that the proposed standard did not go far enough in encouraging auditors to use the work of others.

After considering these comments, the Board continues to believe that a single framework for the auditor's use of the work of others is preferable to separate frameworks for the audit of internal control and the audit of financial statements. The factors used to determine whether and to what extent it is appropriate to use the work of others should be the same for both audits. At the same time, the Board agreed with those commenters who suggested that better integration of the audits could be achieved without replacing the existing auditing standard. The Board therefore has decided to retain AU sec. 322 for both audits and incorporate language into Auditing Standard No. 5 that establishes these integration concepts rather than adopt the proposed standard on considering and using the work of others.

Consistent with the proposal, however, Auditing Standard No. 5 allows the auditor to use the work of others to obtain evidence about the design and operating effectiveness of controls and eliminates the principal evidence provision. Recognizing that issuers might employ personnel other than internal auditors to perform activities relevant to management's assessment of internal control over financial reporting, the final standard allows the auditor to use the work of company personnel other than internal auditors, as well as third parties working under the direction of management or the audit committee.[22]

In line with the overall risk-based approach to the audit of internal control over financial reporting, the extent to which the auditor may use the work of others depends, in part, on the risk associated with the control being tested. As the risk decreases, so does the need for the auditor to perform the work him or herself. The impact of the work of others on the auditor's work also depends on the relationship between the risk and the competence and objectivity of those who performed the work. As the risk decreases, the necessary level of competence and objectivity decreases as well.[23] Likewise, in higher risk areas (for example, controls that address specific fraud risks), use of the work of others would be limited, if it could be used at all.

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[22] See paragraph 17.

[23] See paragraph 18.

Finally, the Board understands that some of the work performed by others for the purposes of management's assessment of internal controls can be relevant to the audit of financial statements. Therefore, in an integrated audit, the final standard allows the auditor to use the work of these sufficiently competent and objective others—not just internal auditors—to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of financial statements.[24] The Board believes that this provision will promote better integration of the audit of internal control with the audit of financial statements.

3. Rule 3525—Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting

The Board also proposed a new rule related to the auditor's responsibilities when seeking audit committee pre-approval of internal control related non-audit services. As proposed, the rule required a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal control-related non-audit services that are not otherwise prohibited by the Act or the rules of the SEC or the Board to: describe, in writing, to the audit committee the scope of the proposed service; discuss with the audit committee the potential effects of the proposed service on the firm's independence; and document the substance of the firm's discussion with the audit committee. These requirements parallel the auditor's responsibility in seeking audit committee pre-approval to perform tax services for an audit client under PCAOB Rule 3524. Most commenters were supportive of the rule as proposed, though some offered suggestions about what should be included in the required communication. After considering the comments on the proposed rule, the Board has adopted it without change.

4. Conforming Amendments

As part of the proposal issued for public comment, the Board proposed amendments to certain of the Board's other auditing standards. Only one comment letter specifically addressed the proposed amendments. That letter expressed support for the amendments and suggested a few additional amendments that might be necessary. The Board has considered this comment and added these additional amendments, as well as others, as necessary based on the final standard.

5. Effective Date

The proposing release solicited commenters' feedback on how the Board could structure the effective date of the final requirements so as to best minimize disruption to ongoing audits, but make greater flexibility available to auditors as early as possible. Most commenters on this topic suggested making the final standard on auditing internal control effective as soon as possible in order to be available for 2007 audits.

The Board agrees that the improvements in Auditing Standard No. 5 should be available as soon as possible. Accordingly, the Board has determined that

[24] See paragraph 17.

Auditing Standard No. 5, Rule 3525, and the conforming amendments will be effective, subject to approval by the SEC, for audits of fiscal years ending on or after November 15, 2007. Earlier adoption is permitted, however, at any point after SEC approval. Auditors who elect to comply with Auditing Standard No. 5 after SEC approval but before its effective date must also comply, at the same time, with Rule 3525 and other PCAOB standards as amended by this release.

Auditing Standard No. 2 will be superseded when Auditing Standard No. 5 becomes effective. Auditors who do not elect to comply with Auditing Standard No. 5 before that date (but after SEC approval) must continue to comply with Auditing Standard No. 2 until it is superseded. Such auditors should, however, apply the definition of "material weakness" contained in Auditing Standard No. 5, rather than the one contained in Auditing Standard No. 2. The SEC has adopted a rule to define the term "material weakness," and the definition in Auditing Standard No. 5 parallels the new SEC definition.

* * *

On the 24th day of May, in the year 2007, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Secretary
June 12, 2007

APPENDICES—

1. Auditing Standard No. 5—*An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements*
2. Rule 3525—Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting
3. Conforming Amendments to PCAOB Auditing Standards
4. Additional Discussion of Comments and the Board's Response

Appendix 1

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

[*Appendix omitted; see Auditing Standard No. 5 for the full text of the standard.*]

Appendix 2

Rule 3525. Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting

In connection with seeking audit committee pre-approval to perform for an audit client any permissible non-audit service related to internal control over financial reporting, a registered public accounting firm shall—

(a) describe, in writing, to the audit committee of the issuer the scope of the service;

(b) discuss with the audit committee of the issuer the potential effects of the service on the independence of the firm; and

Note: Independence requirements provide that an auditor is not independent of his or her audit client if the auditor is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. Several principles guide the application of this general standard, including whether the auditor assumes a management role or audits his or her own work. Therefore, an auditor would not be independent if, for example, management had delegated its responsibility for internal control over financial reporting to the auditor or if the auditor had designed or implemented the audit client's internal control over financial reporting.

(c) document the substance of its discussion with the audit committee of the issuer.

[Effective pursuant to SEC Release No. 34-56152; File No. PCAOB-2007-02; July 27, 2007]

Appendix 3

Conforming Amendments to PCAOB Auditing Standards

[Appendix omitted; see appendix 3 in PCAOB Release No. 2007-005A for a list of the amendments.]

Appendix 4

Additional Discussion of Comments and the Board's Response

As discussed in the first part of the Board's release, on December 19, 2006, the Board proposed for comment a new standard on auditing internal control, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that would replace Auditing Standard No. 2, a related auditing standard, *Considering and Using the Work of Others in an Audit*, an independence rule relating to the auditor's provision of internal control-related non-audit services, and certain amendments to its auditing standards. The Board received 175 comment letters on its proposals and feedback from the Board's Standing Advisory Group.

Notable changes that the Board made in finalizing its proposals in response to comments are described in the first part of the Board's release. This appendix contains a further discussion of comments received on the proposals and the Board's response.

1. Alignment of Board's Internal Control Auditing Standard and the SEC's Guidance to Management

Many commenters suggested that the SEC's guidance to management and the Board's auditing standard should be more closely aligned. The commenters appeared to hold different opinions, however, about what alignment should mean in this context. Some commenters suggested that the most important issue was the need to use the same definitions of important terms in both documents. Some focused on perceived differences in scope, testing, and documentation requirements, while others suggested that the tone of the two documents was different and that the Board's proposals were more prescriptive. A few commenters suggested that the standard on auditing internal control should merely refer to the SEC management guidance without providing additional direction to the auditor.

As discussed more fully in the first part of this release, in formulating a new standard on auditing internal control, the Board intended to describe an audit process that would be coordinated with management's evaluation process. After considering the comments in this area, the Board made several changes, described in the first part of this release, that improve coordination while recognizing the inherent differences in the roles of management and the independent auditor under Section 404. The Board also adopted, as proposed, the final standard without a requirement for the auditor to perform an evaluation of management's assessment process. Commenters generally supported this aspect of the proposal, which was intended to respond to concerns that the requirements of Auditing Standard No. 2 had become de facto guidance for management's process. The absence of this requirement in the final standard should also allow for improved coordination between management and the auditor.

2. Level of Prescriptive Detail

Some commenters suggested that there remained too many instances of the use of the terms "should" and "must" in the proposed standard and that this might drive excessive documentation and possibly unnecessary work. The Board's Rule 3101 describes the level of responsibility that these imperatives impose on auditors when used in PCAOB standards, and the Board uses these terms in

its standards to clearly convey its expectations. In response to these comments, the Board analyzed each requirement in the proposed standard to determine whether more reliance could be placed on general principles rather than detailed requirements. Where appropriate, the Board made modifications to make the final standard more principles-based. As discussed more fully in the first part of this release, areas in which changes were made include the focus on fulfilling the objectives of a walkthrough and in the description of the top-down approach. Some of these changes also contributed to better coordination with the SEC's guidance for management.

In addition, several commenters expressed concern over the creation of presumptively mandatory responsibilities related to efficiency concepts. The example cited most often was the note to paragraph 3 of the proposed standard on auditing internal control, which stated—

> Note: The auditor should select for testing only those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to a given relevant assertion that could result in a material misstatement to the company's financial statements.

Commenters suggested that because of this requirement for the auditor to select "only those controls that are important" for testing, an auditor would have violated the Board's standards if he or she tested even one control that was later shown to be not important. Commenters believed that this would undermine audit effectiveness and recommended removal of such statements.

One of the objectives of the revised standard is to encourage auditors to focus on those areas that present the greatest risk of allowing a material misstatement in the financial statements. However, the Board agrees that its standards should not define a ceiling or maximum amount of work which the auditor may not exceed. While this statement (and others like it) in the proposed standard was not intended to imply that the Board would, with hindsight, suggest that an auditor violated the standard through testing of a control that was later determined to be not important to the audit, the Board has removed the note to paragraph 3 in response to these comments. Similar statements throughout the standard have also either been removed or modified.

3. Walkthroughs

The proposed standard required that the auditor perform a walkthrough of each significant process each year and allowed the auditor to use others, such as management personnel and internal auditors, to directly assist the auditor in this work. The proposed standard also indicated that the walkthrough provides audit evidence but did not prescribe further requirements regarding the circumstances in which a walkthrough might provide the auditor with sufficient evidence of operating effectiveness for a particular control. The proposing release, however, noted that a walkthrough could be sufficient for some low-risk controls in subsequent years.

As discussed in the first part of this release, the Board received a significant number of comments on this topic. While several commenters expressed support for the importance of the walkthrough to audit quality, many commenters suggested that the proposed provisions in this area were more prescriptive than necessary, and suggested risk concepts as a way to add flexibility. While these commenters acknowledged the value of a walkthrough and its importance to the evaluation of design effectiveness, many stated that the requirement to perform a walkthrough in an area that is either low-risk, not complex, or

unchanged appears inconsistent with the other areas in the proposed standard that rely upon auditor judgment to a much greater extent.

Use of others in achieving the objectives of a walkthrough

Commenters supported allowing the auditor to use others to provide the auditor with direct assistance, particularly in low-risk areas, with only a few commenters believing that this change could jeopardize the quality of the audit. In addition, many commenters believed that the standard should allow full use of the work of others in performing walkthroughs, although some commenters strongly disagreed with this point.

As discussed in the first part of this release, the final standard focuses the auditor on achieving four objectives related to the identification of where within the company's processes misstatements could arise, rather than specifically on performing walkthroughs. Due to the importance of achieving these objectives to the auditor's conclusion about internal control, the Board believes that allowing the use of the work of others to a greater extent than what was proposed would not provide the auditor with an adequate understanding of the relevant risks and the related controls. Therefore, similar to the proposed standard, Auditing Standard No. 5 allows the auditor to use the work of others in achieving the objectives of a walkthrough, but only as direct assistance. That is, the auditor will be required to supervise, review, evaluate, and test the work performed by others.[1]

Using walkthroughs to test operating effectiveness

On the subject of using walkthroughs to test operating effectiveness, commenters suggested that walkthroughs can provide sufficient evidence of operating effectiveness, but held different views about situations in which this would be the case. Some commenters supported the use of walkthroughs in low-risk areas, while others focused on whether the control itself should be low-risk. Several commenters suggested that a walkthrough could provide sufficient evidence of operating effectiveness for lower-risk controls but only when entity-level controls are strong. Almost all commenters agreed that the proposed standard focused on the appropriate conditions for using such an approach—specifically, when risk is low, when past audits indicate effective design and operation of the control, and when no changes have been made to the control or process in which the control resides.

After considering these comments, the Board has decided that the risk-based approach that is described in the final standard is the appropriate framework for determining the evidence necessary to support the auditor's opinion. Therefore, Auditing Standard No. 5 articulates the principle that performance of a walkthrough might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthroughs and the results of the procedures performed.[2] The Board believes that establishing more detailed requirements in this area is not necessary, because application of the general principle in the standard will depend on the particular facts and circumstances presented.

4. Assessing Risk

The Board's May 16, 2005 guidance emphasized the importance of risk assessment in the audit of internal control, and that element of the guidance was

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[1] See paragraph 27 of AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.

[2] See paragraph 49.

incorporated and enhanced in the proposed standard. The proposed standard required risk assessment at each of the decision points in a top-down approach, including the auditor's identification of significant accounts and disclosures and their relevant assertions. The proposed standard also required an assessment of risk at the individual control level, and required that the auditor determine the evidence necessary for a given control based on this risk assessment.

The Board received many comments on the risk assessment provisions in the proposed standard. Comments on the proposed risk assessment approach were generally supportive, with some commenters suggesting ways for improving the risk assessment emphasis in the standard. Many commenters discussed the requirement in the proposed standard for the auditor to assess the risk that the control might not be effective and, if not effective, the risk that a material weakness would result for each control the auditor selected for testing. Commenters suggested that this requirement conflicted with both current practice and the requirements within the interim standards for the financial statement audit, which involve risk assessment at the financial statement assertion level. These commenters believed that this requirement would result in risk assessments at both the assertion level and the individual control level and suggested that assessing (and documenting) risk at the relevant assertion level is sufficiently precise to drive appropriate audits. Furthermore, they believed that a specific requirement to assess risk at the individual control level and its associated documentation requirement would be unnecessary.

After considering these comments, the Board continues to believe that the auditor may vary the nature, timing, and extent of testing based on the assessed risk related to a control. Making this assessment a presumptively mandatory requirement, as it was in the proposed standard, however, does not appear necessary to achieve the intended benefits of varied testing based on the risk associated with a control. Auditing Standard No. 5, therefore, requires the auditor to assess the risk related to the relevant assertion, but not the risk at the individual control level. The standard permits the auditor to consider the risk at the control level, however, and alter the nature, timing, and extent of testing accordingly.

Several commenters expressed concern about the advisability of taking a risk-based approach and the adequacy of the Board's interim standards regarding risk assessment. These commenters suggested that auditors have frequently been unsuccessful at applying a risk-based approach to the financial statement audit in the past.

The Board has found the arguments for a more principles-based approach to internal control auditing convincing, and the principle that the auditor should vary the testing to respond to the risk is one of the most important in the standard. Early implementation of Auditing Standard No. 2 demonstrated that, when internal control is audited without adequate consideration of risk, the areas that pose the greatest danger of material misstatement may be obscured or lost. The emphasis on risk, therefore, drives an audit that is more effective and focused. While the Board believes that auditors can appropriately assess risk based on the interim auditing standards, it has committed to examining the existing standards in this area to see where improvements can be made. This is currently one of the Board's standard setting priorities.

5. Evaluation of Deficiencies

The Board received a substantial number of comments on the topic of evaluating deficiencies, including comments on the proposed definitions of material weakness and significant deficiency, the "strong indicators" of a material weakness, and the requirement to evaluate all identified deficiencies. While a

number of commenters stated that auditors do identify material weaknesses in the absence of an actual material misstatement, some noted that, in many cases, material weaknesses are identified only when material misstatements are discovered. Several commenters suggested that the proposed standard, with its focus on using a top-down approach and scoping to identify material weaknesses, would allow auditors to do a more thorough review of the most important controls with less effort expended on reviewing lower risk controls. These commenters often stated that this approach should increase the likelihood of the auditor detecting material weaknesses before a material misstatement occurs.

Definition of a material weakness

The proposed standard retained the basic framework in Auditing Standard No. 2 that described material weaknesses by reference to the likelihood and magnitude of a potential misstatement. While the Board believed that framework to be sound, it made an effort to clarify the definition in the proposed standard by replacing the reference to "more than remote likelihood" with "reasonable possibility." Financial Accounting Standards Board ("FASB") Statement No. 5 describes the likelihood of a future event occurring as "probable," "reasonably possible," or "remote." The definition in Auditing Standard No. 2 referred to a "more than remote" likelihood of a misstatement occurring. In accordance with FASB Statement No. 5, the likelihood of an event is "more than remote" when it is either "reasonably possible" or "probable."

As the Board noted in the proposing release, however, some auditors and issuers have misunderstood the term "more than remote" to mean something significantly less likely than a reasonable possibility. This, in turn, could have caused these issuers and auditors to evaluate the likelihood of a misstatement at a much lower threshold than the Board intended. Because the term "more than remote" could have resulted in auditors and issuers evaluating likelihood at a more stringent level than originally intended, the Board proposed changing the definition to refer to a "reasonable possibility."

Commenters on this change were split between those that felt the change would reduce unnecessary effort spent on identifying and analyzing deficiencies, and those who believed it would not. Several commenters noted that the replacement of the term "more than remote likelihood" with the term "reasonable possibility" does not raise the auditor's threshold for classifying deficiencies. According to those commenters, the change simply attempts to align the description of the threshold for identifying deficiencies with previous guidance issued by the PCAOB. The Board continues to believe that the proposed definition—as well as Auditing Standard No. 2—established an appropriate threshold for the likelihood part of the definition of material weakness. While the Board agrees that, as a definitional matter, "reasonable possibility" and "more than remote" describe the same threshold, it believes that "reasonable possibility" describes that threshold more appropriately and clearly, and will therefore avoid the misunderstanding of the threshold created by the way it was described in Auditing Standard No. 2. As a result, it retained that term in the final definition in the standard.

In addition, some commenters noted that the definitions of material weakness and significant deficiency in the proposed standard, like the definitions in Auditing Standard No. 2, referred to the likelihood of a material misstatement in both the interim and annual financial statements. Most of these commenters suggested that the Board remove the term "interim" from the definitions of material weakness and significant deficiency because, according to the commenters, it causes confusion when scoping the audit of internal control and unnecessarily complicates the evaluation of deficiencies, particularly in the

absence of guidance from the SEC and FASB regarding interim materiality. Some commenters, however, said that the Board should not remove the term "interim" from the definitions because the evaluation of deficiencies should be performed to consider the effectiveness of internal control for both the interim and annual financial statements. After carefully considering these comments, and in order to use the same definition that the SEC uses in its guidance to management, the Board determined to retain the reference to interim financial statements in the final definition of material weakness.[3]

Indicators of a material weakness

The proposed standard described circumstances that should be regarded as strong indicators of a material weakness in internal control. The proposing release noted that the identification of one of these strong indicators should bias the auditor toward a conclusion that a material weakness exists but does not require the auditor to reach that conclusion. Under the proposal, the auditor could determine that these circumstances do not rise to the level of a material weakness, and in some cases, are not deficiencies at all.

Many commenters supported the proposed changes from Auditing Standard No. 2 relating to strong indicators, agreeing that, by allowing greater use of professional judgment in this area, practice will improve. A few commenters stated that these changes may lead to some inconsistency in practice, but consistent with other commenters, they still supported the use of greater professional judgment in the evaluation of deficiencies. At least one commenter suggested that several of the strong indicators were not indicators of a material weakness but should be, under all circumstances, a material weakness. A few commenters also suggested that the list of strong indicators in Auditing Standard No. 2 actually stifles the auditor's judgment to the point that auditors fail to identify material weaknesses that exist because the deficiency is not on the list of strong indicators. These commenters suggested that removing the list of strong indicators entirely would be best.

The Board believes that auditor judgment is imperative in determining whether a deficiency is a material weakness and that the standard should encourage auditors to use that judgment. At the same time, the Board continues to believe that highlighting certain circumstances that are indicative of a material weakness provides practical information about the application of the standard. As a result, the Board has included this information in the final standard but has taken a more principles-based approach. Additionally, the Board has coordinated with the SEC so that the indicators in the auditing standard parallel those in the SEC's management guidance.

Rather than referring to "strong indicators," the final standard refers simply to "indicators" of material weakness.[4] The standard also makes clear that the list of indicators is not exhaustive and should not be used as a checklist. Specifically,

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[3] The provisions in the final standard relating to significant deficiencies are discussed in the first part of this release. As discussed in the first part of this release, the Board also made minor wording changes to the definition of material weakness in order to use the same definition as the SEC in its guidance to management and related rules.

[4] The Board included as an indicator the proposed standard's requirement to determine the level of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. In the proposal, if the auditor determined that a deficiency would prevent prudent officials from concluding that they have such reasonable assurance, the auditor was required to deem the deficiency to be at least a significant deficiency. Under the final standard, if the auditor determines that a deficiency might prevent prudent officials from concluding that they have such reasonable assurance, this circumstance is an indicator of material weakness.

under the final standard, the presence of one of the indicators does not mandate a conclusion that a material weakness exists. At the same time, a deficiency that is not a listed indicator may be a material weakness.

The Board did not adopt as indicators in the final standard certain proposed strong indicators. The Board believes, as at least one commenter suggested, that some of these proposed strong indicators are better characterized as material weaknesses rather than as indicators of a material weakness.[5] Including them in the list of indicators, as adopted, would therefore be inconsistent with the degree of judgment required to evaluate whether an indicator of a material weakness is, under particular facts and circumstances, a material weakness.

Requirement to evaluate all identified deficiencies

The proposed standard required the auditor to evaluate the severity of each control deficiency that comes to his or her attention. The same provision in the proposed standard made clear, however, that the auditor need not scope the audit to find control deficiencies that are less severe than material weaknesses. A few commenters believed that this requirement is not necessary and suggested that an acceptable alternative would be for the auditor to verify that management has evaluated all deficiencies.

The Board continues to believe that the auditor needs to evaluate all deficiencies that come to his or her attention. Without such an evaluation, there would not be a sufficient basis for the auditor's opinion.

6. Additional Scoping and Materiality Issues

The proposed standard clarified that the auditor should plan and perform the audit of internal control using the same materiality measures used to plan and perform the audit of the annual financial statements. This direction was intended to address concerns that auditors have interpreted Auditing Standard No. 2 as directing them to search for potential defects in internal control at a lower materiality level than that used in the audit of the annual financial statements.

The Board received many comments on materiality and scoping, and a large portion of the commenters expressed support for the proposed standard's approach. Some commenters, however, recommended providing clear quantitative guidelines for calculating materiality. Other commenters expressed concern about such an approach, fearing that material areas would be inappropriately excluded from the audit scope. Finally, some commenters suggested that the Board should provide additional guidance on scoping and extent of control testing decisions, such as guidance on sample sizes related to testing of high-risk controls versus low-risk controls or more specific guidance on the scope of the internal control audit for entities with multiple locations.[6]

After considering these comments, the Board has determined to adopt its discussion of materiality in the internal control audit as proposed. The Board

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[5] One such proposed strong indicator was an ineffective control environment. Under the proposal, indicators of an ineffective control environment included identification of fraud on the part of senior management and significant deficiencies that have been communicated to management and the audit committee and remain uncorrected after some reasonable period of time. The final standard includes the identification of fraud on the part of senior management as an indicator of a material weakness. In order to simplify the list and make it more principles-based, as well as to align it with the SEC management guidance, however, the Board did not include significant deficiencies that remain uncorrected as an indicator in the final standard.

[6] The proposed standard focused on the auditor's assessment of risk of material misstatement and how the auditor could carry that assessment process into the scoping of a multi-location audit. Commenters were very supportive of the Board's approach in this area and, consequently, the Board has determined to adopt these provisions as proposed.

believes that the auditing standard on internal control is an inappropriate place to redefine or refine the meaning of materiality, which is a long-established concept in the federal securities laws. With respect to requests for more specific guidance on scoping or extent of testing issues, the Board has, as discussed in the first part of this release, endeavored to adopt a standard that relies more on general principles than detailed requirements. Accordingly, the Board believes that auditors should make specific determinations of how to comply with the general scoping and testing requirements in the standard using professional judgment in the particular circumstances presented.

7. Scaling the Audit for Smaller Companies

As discussed in the first part of this release, the Board received many comments on the proposed section on scaling the audit from commenters with a variety of perspectives. The comments covered a wide range of issues. In addition to the matters discussed in the first part of this release, commenters suggested:

- That the proposed section on scalability should be focused more closely on how complexity relates to a risk-based audit;
- That the proposed standard did not provide sufficient flexibility for smaller companies and that the standard should provide for more "credit" for control testing based on work done as part of the financial statement audit;
- That the resulting costs of these proposed changes would need to be studied for several years to determine if they are appropriate;
- That the attributes of smaller, less complex companies that were included in the proposed standard were appropriate and that the tailoring directions for auditors were adequate;
- That some of the attributes of smaller, less complex companies that might allow the auditor to tailor the audit might be, instead, risk factors that require more testing;
- That the emphasis on entity-level controls might not be appropriate; and
- That the Board's project to develop guidance on auditing internal control in smaller public companies is necessary.

As discussed in the first part of this release, the Board made several changes in response to comments in the final standard. The new standard provides direction on how to tailor internal control audits to fit the size and complexity of the company being audited. It does so by including notes throughout the standard on how to apply the principles in the standard to smaller, less complex companies, and by including a discussion of the relevant attributes of smaller, less complex companies as well as less complex units of larger companies. The Board believes that the final standard appropriately considers the circumstances of smaller and less complex public companies (and other companies with less complex business units) while requiring a high-quality audit regardless of company size or complexity. The planned guidance on this topic will provide additional practical information for auditors of smaller companies.

8. Information Technology Principles

In gaining an understanding of the effect of information technology ("IT") on internal control over financial reporting and the risks the auditor should assess, the proposed standard directed the auditor to apply guidance in AU sec. 319,

Consideration of Internal Control in a Financial Statement Audit. Additionally, the proposed standard included a discussion of IT operations at smaller and less complex companies. A number of commenters discussed the importance of IT risks to determining the scope of the audit and recommended that the final standard include additional guidance on how the risk assessment related to IT is incorporated in the audit of internal control.

In response to these comments, the Board included in Auditing Standard No. 5 a note to paragraph 36 that clarifies that the identification of risks and controls within IT should not be a separate evaluation but, rather, an integral part of the auditor's top-down risk assessment, including identification of significant accounts and disclosures and their relevant assertions, as well as the controls to test.

9. Roll-forward Procedures

The proposed standard discussed the procedures the auditor should perform to obtain additional evidence concerning the operation of the control when the auditor reports on the effectiveness of the control "as of" a specific date, but has tested the effectiveness of the control at an interim date. The Board received a few comments on this topic, mainly from auditors. The comments were consistent in their view that the proposed standard improperly implies, by using the expression "if any" in relation to additional evidence the auditor is required to obtain, that the auditor may not need to do any roll-forward work. Commenters suggested that such an approach would be inconsistent with paragraph .99 of AU sec. 319 and suggested that the words "if any" be removed from the final standard. The Board believes that its standard should be consistent with AU sec. 319.99 in that the auditor should perform some level of roll-forward procedures. Consequently, the Board removed the words "if any" from the relevant paragraphs of Auditing Standard No. 5 to correct the inconsistency. The Board also noted that, in some circumstances, inquiry alone might be a sufficient roll-forward procedure.

10. Cumulative Knowledge and Rotation

The proposed standard on auditing internal control allowed the auditor to incorporate knowledge from previous years' audits into his or her decision making process for determining the nature, timing, and extent of testing necessary. The section in the proposed standard on special considerations for subsequent years' audits built upon the risk-based framework in the proposed standard for determining the nature, timing and extent of testing by describing certain additional factors for the auditor to evaluate in subsequent years. These factors included the results of prior years' testing and any change that may have taken place in the controls or the business since that testing was performed. This section retained the requirement in Auditing Standard No. 2 that each control deemed important to the auditor's conclusion be tested every year, but allowed for a reduction in testing when the additional risk factors indicated that the risk was lower than in the past.

Many commenters strongly supported these provisions as proposed. Many investors, in particular, stated that while they supported the proposed approach, they would not be supportive of rotation of control testing over a multiple-year period. These commenters were generally concerned that rotation of control testing would negatively affect audit quality. Among supporters of the approach in the proposed standard, several requested further clarification in the standard or additional guidance on how this approach should affect the level of testing.

Many issuers suggested that the standard should allow for full rotation—which exempts some important controls from testing each year—of at least controls in low-risk areas. Other commenters recommended that all controls should be tested on a multiyear rotating basis. These comments often focused on the fact that while the proposed standard required the auditor to evaluate whether there had been any relevant changes since the control was tested, it still required testing at some level even when there had been no change. These commenters considered this requirement to be unnecessary.

The Board shares the concern that multi-year rotation of control testing would not provide sufficient evidence for the auditor's opinion on internal control effectiveness, which is required by the Act to be issued each year. In the financial statement audit, control testing plays a supporting role—to the extent that controls have been tested and are effective, the auditor can reduce the level of (but not eliminate) the necessary substantive testing. In contrast, in the internal control audit, control testing does not play a supporting role but is the sole basis for the auditor's opinion. Additionally, even if the design of the control and its related process does not change from the prior year, it is not possible to assess the control's operating effectiveness without performing some level of testing. For these reasons, rotation is not a viable option in the audit of internal control.

Instead, the approach described in the proposed standard has been clarified in the final standard and continues to focus the auditor on relevant changes since a particular control was last tested, as many commenters suggested. Under this approach, the auditor would consider, in addition to the risk factors described in the standard that are always relevant to determining the nature, timing, and extent of testing, whether there has been a change in the controls or in the business that might necessitate a change in controls; the nature, timing, and extent of procedures performed in previous audits; and the results of the previous years' testing of the control.[7] After taking into account these additional factors, the additional information in subsequent years' audits might permit the auditor to assess risk as lower than in the initial year and, thus, might permit the auditor to reduce testing.

This treatment of cumulative knowledge is analogous to the roll-forward provisions in the final standard. In the case of subsequent years, the auditor, in essence, rolls forward the prior years' testing when the control was found to be effective in the past and no change has occurred (or would have been expected to occur due to changes in the environment or process that contains the control). Because the auditor might be able to assess the risk lower in the subsequent years, a walkthrough, or equivalent procedures, might be sufficient for low-risk controls. This approach appropriately factors in the effect of cumulative knowledge, while maintaining audit quality and providing a sufficient basis for the auditor's opinion.

11. Reporting the Results of the Audit

In the proposed standard, the Board attempted to address concerns that the separate opinion on management's assessment required by Auditing Standard No. 2 contributed to the complexity of the standard and caused confusion regarding the scope of the auditor's work.[8] Accordingly, to emphasize the proper scope of the audit and to simplify the reporting, the proposed standard required

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[7] See paragraph 55.

[8] Although Auditing Standard No. 2 requires the auditor to evaluate management's process, the auditor's opinion on management's assessment is not an opinion on management's internal control evaluation process. Rather, it is the auditor's opinion on whether management's statements about the effectiveness of the company's internal controls are fairly stated.

that the auditor express only one opinion on internal control—a statement of the auditor's opinion on the effectiveness of the company's internal control over financial reporting. The proposal eliminated the separate opinion on management's assessment because it was redundant of the opinion on internal control itself and because the opinion on the effectiveness of controls more clearly conveys the same information—specifically, whether the company's internal control is effective.

Many commenters agreed with the Board that eliminating the separate opinion on management's assessment would reduce confusion and clarify the reporting. Some commenters, however, suggested that the Board should instead require only an opinion on management's assessment. These commenters expressed their belief that the Act requires only that the auditor review management's assessment process and not the company's internal control. Additionally, a few commenters expressed confusion about why the proposed standard continued to reference an audit of management's assessment in paragraph 1 of the proposed standard and the auditor's report.

The Board has determined, after considering these comments, to adopt the provision requiring only an opinion on internal control.[9] The Board continues to believe that the overall scope of the audit that was described by Auditing Standard No. 2 and the proposed standard is correct; that is, to attest to and report on management's assessment, as required by Section 404(b) of the Act, the auditor must test controls directly to determine whether they are effective.[10] Accordingly, paragraphs 1 and 2 of the proposed standard provided that the auditor audits management's assessment—the statement in management's annual report about whether internal control is effective—by auditing whether that statement is correct—that is, whether internal control is, in fact, effective. The final standard similarly makes this clear. In response to commenters, however, the Board has clarified the auditor's report so that it will consistently refer to the required audit as the audit of internal control.

12. Implementation

Some commenters urged the Board to focus on implementation issues after it adopts a final standard, and noted that effective implementation by the Board is crucial to the internal control reporting process. Some of these commenters focused on the inspections process, which they suggested is key to promoting audit efficiency. Some stated that auditors would be unlikely to change their audit approach until they are confident that the inspections will be similarly focused. The Board is committed to effective monitoring of firms' compliance with the new standard and will continue to promote proper implementation through other means, including the Board's Forums on Auditing in the Small Business Environment and guidance for auditors of smaller companies.

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[9] The SEC has adopted changes to its rules that require the auditor to express an opinion directly on internal control.

[10] In addition, Section 103 of the Act requires the Board's standard on auditing internal control to include "testing of the internal control structure and procedures of the issuer. . . " Under Section 103, the Board's standard also must require the auditor to present in the audit report, among other things, "an evaluation of whether such internal control structure and procedures. . . provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles. . . "

Auditing Standard No. 6

Evaluating Consistency of Financial Statements

[Supersedes AU secs. 420 and 9420]

Source: Auditing Standard Nos. 8–15.

[Effective pursuant to SEC Release No. 34-58555, File No. PCAOB-2008-01 (September 16, 2008).]

Consistency and the Auditor's Report on Financial Statements

1. This standard establishes requirements and provides direction for the auditor's evaluation of the consistency of the financial statements, including changes to previously issued financial statements, and the effect of that evaluation on the auditor's report on the financial statements.

2. To identify consistency matters that might affect the report, the auditor should evaluate whether the comparability of the financial statements between periods has been materially affected by changes in accounting principles or by material adjustments to previously issued financial statements for the relevant periods.

3. The periods covered in the auditor's evaluation of consistency depend on the periods covered by the auditor's report on the financial statements. When the auditor reports only on the current period, he or she should evaluate whether the current-period financial statements are consistent with those of the preceding period. When the auditor reports on two or more periods, he or she should evaluate consistency between such periods and the consistency of such periods with the period prior thereto if such prior period is presented with the financial statements being reported upon.[1] The auditor also should evaluate whether the financial statements for periods described in this paragraph are consistent with previously issued financial statements for the respective periods.[2]

> Note: The term "current period" means the most recent year, or period of less than one year, upon which the auditor is reporting.

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[1] For example, assume that a company presents comparative financial statements covering three years and has a change in auditors. In the first year in which the successor auditor reports, the successor auditor evaluates consistency between the year on which he or she reports and the immediately preceding year. In the second year in which the successor auditor reports, the successor auditor would evaluate consistency between the two years on which he or she reports and between those years and the earliest year presented.

[2] When a company uses retrospective application, as defined in Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("SFAS No. 154"), to account for a change in accounting principle, the financial statements presented generally will be consistent. However, the previous years' financial statements presented with the current year's financial statements will reflect the change in accounting principle and, therefore, will appear different from those previous years' financial statements on which the auditor previously reported. This standard clarifies that the auditor's evaluation of consistency should encompass previously issued financial statements for the relevant periods.

4. The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:

a. A change in accounting principle

b. An adjustment to correct a misstatement in previously issued financial statements.[3]

Change in Accounting Principle

5. A change in accounting principle is a change from one generally accepted accounting principle to another generally accepted accounting principle when (1) there are two or more generally accepted accounting principles that apply, or when (2) the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle.[4]

Note: A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of a misstatement.

6. The auditor should evaluate and report on a change in accounting estimate effected by a change in accounting principle like other changes in accounting principle.[5] In addition, the auditor should recognize a change in the reporting entity[6] by including an explanatory paragraph in the auditor's report, unless the change in reporting entity results from a transaction or event. A change in reporting entity that results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit does not require recognition in the auditor's report.

7. The auditor should evaluate a change in accounting principle to determine whether—

a. The newly adopted accounting principle is a generally accepted accounting principle,

b. The method of accounting for the effect of the change is in conformity with generally accepted accounting principles,

c. The disclosures related to the accounting change are adequate,[7] and

d. The company has justified that the alternative accounting principle is preferable.[8]

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[3] *[Footnote deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[4] See SFAS No. 154, paragraph 2c.

[5] SFAS No. 154, paragraph 2e, defines a "change in accounting estimate effected by a change in accounting principle" as "a change in accounting estimate that is inseparable from the effect of a related change in accounting principle."

[6] "Change in reporting entity" is a change that results in financial statements that, in effect, are those of a different reporting entity. See SFAS No. 154, paragraph 2f.

[7] Newly issued accounting pronouncements usually set forth the method of accounting for the effects of a change in accounting principle and the related disclosures. SFAS No. 154 sets forth the method of accounting for the change and the related disclosures when there are no specific requirements in the new accounting pronouncement.

[8] The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. See SFAS No. 154, paragraph 14.

8. A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements. If the auditor concludes that the criteria in paragraph 7 have been met, the auditor should add an explanatory paragraph to the auditor's report, as described in AU sec. 508, *Reports on Audited Financial Statements*. If those criteria are not met, the auditor should treat this accounting change as a departure from generally accepted accounting principles and address the matter as described in AU sec. 508.

Note: If a company's financial statements contain an investment accounted for by the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting principle that is material to the investing company's financial statements, the auditor should add an explanatory paragraph (following the opinion paragraph) to the auditor's report, as described in AU sec. 508.

Correction of a Material Misstatement in Previously Issued Financial Statements

9. The correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, as described in AU sec. 508.

10. *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The accounting pronouncements generally require certain disclosures relating to restatements to correct misstatements in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the inadequacy of disclosure as described in paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*, and AU sec. 508.

Change in Classification

11. Changes in classification in previously issued financial statements do not require recognition in the auditor's report, unless the change represents the correction of a material misstatement or a change in accounting principle. Accordingly, the auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. For example, certain reclassifications in previously issued financial statements, such as reclassifications of debt from long-term to short-term or reclassifications of cash flows from the operating activities category to the financing activities category, might occur because those items were incorrectly classified in the previously issued financial statements. In such situations, the reclassification also is the correction of a misstatement. If the auditor determines that the reclassification is a change in accounting principle, he or she should address the matter as described in paragraphs 7 and 8 and AU sec. 508. If the auditor determines that the reclassification is a correction of a material misstatement in previously issued financial statements, he or she should address the matter as described in paragraphs 9 and 10 and AU sec. 508.

Attachment

PCAOB Release No. 2008-001

January 29, 2008
PCAOB Rulemaking
Docket Matter No. 023

Summary

After public comment, the Public Company Accounting Oversight Board is adopting Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, and amendments to the Board's interim auditing standards.

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A. Introduction

The Board proposed certain changes to its auditing standards in response to two actions of the Financial Accounting Standards Board ("FASB"). In May 2005, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 154, *Accounting Changes and Error Corrections*,[1] which superseded Accounting Principles Board ("APB") Opinion No. 20, *Accounting Changes*.[2] The FASB has also issued an exposure draft of a proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles.*[3]

SFAS No. 154 establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to a newly adopted accounting principle.[4] SFAS No. 154 also redefines the term "restatement" to refer only to "the process of revising previously issued financial statements to reflect the correction of an error in those financial statements."[5] Under SFAS No. 154, therefore, the term "restatement" does not refer to changes made to previously issued financial statements to reflect a change in accounting principle.

AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*, the Board's interim standard on the auditor's responsibilities for evaluating the consistency of the application of generally accepted accounting principles ("GAAP"), generally reflected the provisions of APB Opinion No. 20, which

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[1] Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Standards ("SFAS") No. 154, *Accounting Changes and Error Corrections* (2005) ("SFAS No. 154").

[2] Accounting Principles Board ("APB") Opinion No. 20, *Accounting Changes* (1971). SFAS No. 154 also superseded SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*.

[3] FASB, Proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles,* Exposure Draft (April 2005).

[4] Among other reasons for undertaking this project, the FASB intended to eliminate differences between APB Opinion No. 20 and the International Accounting Standards Board standard, IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. See introduction to SFAS No. 154.

[5] See SFAS No. 154, paragraph 2j.

was superseded by SFAS No. 154. To better align the Board's standards with the new accounting standard, on April 3, 2007, the Board proposed a new auditing standard on evaluating consistency, which would supersede AU sec. 420, and conforming amendments to AU sec. 508, *Reports on Audited Financial Statements*, of its interim auditing standards.

The FASB's proposed standard on the GAAP hierarchy would incorporate the hierarchy found in the auditing standards into the accounting standards. Historically, a description of the GAAP hierarchy has resided only in the auditing standards.[6]

Because the GAAP hierarchy identifies the sources of accounting principles and the framework for selecting principles to be used in preparing financial statements, the Board believed that these requirements are more appropriately located in the accounting standards. Accordingly, also on April 3, 2007, the Board proposed to remove the GAAP hierarchy from the auditing standards.[7]

The proposed standard provided direction for the auditor's evaluation of the consistency of financial statements. It directed the auditor to recognize a change in accounting principle or an adjustment to correct a misstatement[8] in previously issued financial statements in the auditor's report if it had a material effect on the financial statements. The conforming amendments to AU sec. 508, *Reports on Audited Financial Statements*, provide language for the explanatory paragraph. The proposed standard also directed the auditor to review a material change in financial statement classification and the related disclosure to determine whether the change also is a change in accounting principle or a correction of a material misstatement.

The proposed standard and amendments were intended to update and clarify the auditing standards in light of SFAS No. 154 and the FASB's proposal on the GAAP hierarchy. In particular, these updates and clarifications should enhance the clarity of auditor reporting on accounting changes and corrections of misstatements by distinguishing between these events.

The Board received 11 comment letters. In general, the commenters were supportive of the proposed standard and amendments. They generally stated that the proposed auditing standard appropriately described how the auditor should evaluate the consistency of financial statements and reflected the changes to accounting requirements under SFAS No. 154. Several commenters suggested clarifications in various parts of the standard. As described in the following sections, the Board has considered the comments and made changes to the final standard and amendments.

The Board is adopting the proposed standard as Auditing Standard No. 6, as well as the amendments to the interim standards. This release describes key aspects and elements of the new standard and amendments, comments received, and changes incorporated in the final standard.

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[6] See AU sec. 411, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles."* Although the Board is removing the GAAP hierarchy from this standard, the standard remains in existence, as amended.

[7] If the amendments are approved by the SEC, the effective date for the removal of the GAAP hierarchy from the auditing standards will be 60 days after the standard and amendments are approved by the SEC. The Board has coordinated with the FASB and understands that the FASB intends to coincide the effective date of its standard on the GAAP hierarchy with that of the PCAOB.

[8] SFAS No. 154 uses the term "error" instead of "misstatement." This release, including the final standard and amendments, uses "misstatement," the prevailing term used in PCAOB auditing standards. The term "error," as used in SFAS No. 154, is equivalent to "misstatement," as used in the auditing standards.

B. Evaluating Consistency

Under Auditing Standard No. 6, auditors are required to evaluate the consistency of a company's financial statements and report on inconsistencies. The new standard updates these requirements and aligns them more closely with SFAS No. 154[9] by requiring the auditor's report to recognize a company's correction of a material misstatement, regardless of whether it involves the application of an accounting principle. Based on a discussion at an October 2005 meeting of the Board's Standing Advisory Group, the Board understands that this requirement is consistent with current practice. The new standard focuses on the auditor's responsibilities regarding events that warrant recognition in the auditor's report on the financial statements–changes in accounting principles and corrections of misstatements in previously issued financial statements.[10] This standard also clarifies that the auditor's report should indicate whether an adjustment to prior-period financial statements results from a change in accounting principle or the correction of a misstatement.

1. Materiality

There were several comments on materiality. Some commenters suggested that the standard should specifically state that the auditor need not recognize the correction of a misstatement that is immaterial to the previously issued financial statements. Another suggested that the standard should remind the auditor that professional judgment is required to evaluate consistency. Another commenter said that additional guidance on materiality as applied to individual matters in the financial statements would be helpful in applying the standard. Others suggested that clarity would be improved by inserting the word "material" in several places.

In general, the Board's view is that the purpose of the standard is to provide direction on evaluating consistency; for example, the accounting periods the auditor should evaluate, the recognition in the auditor's report of consistency matters prescribed by the accounting standards, and the related audit reporting requirements. Because an audit is predicated on the use of reasoned judgment and the consideration of materiality in planning, performing, and reporting on the audit, the Board does not believe it is necessary for this standard to specifically direct the auditor to exercise judgment and apply materiality. Further, materiality is a concept that is defined under the federal securities laws, and it is not the objective of this standard to alter or interpret that concept.

The Board did agree that clarity could be improved in some areas by inserting the word "material" to modify the word "misstatement." The Board added "material" to AU secs. 508.18A and B to be consistent with paragraph 4 of Auditing Standard No. 6. However, AU sec. 508.18C does not include "material" because that sentence summarizes the SFAS No. 154 requirement for correcting a misstatement, which does not directly mention materiality.

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[9] Because SFAS No. 154 provides comprehensive, authoritative accounting guidance on changes in accounting principle and corrections of errors, Auditing Standard No. 6 omits the accounting guidance that was included in AU sec. 420.

[10] AU sec. 420 also required recognition of those events. However, it only required recognition in the auditor's report of the correction of a misstatement involving an accounting principle. In addition, unlike AU sec. 420, the new standard does not describe the accounting changes that do not require recognition in the auditor's report.

2. Periods Covered by the Evaluation of Consistency

The new standard describes the scope of the required evaluation of consistency in terms that are similar to the description in AU sec. 420. Under the new standard, when the auditor reports only on the current period, the auditor should evaluate whether the financial statements of the current period are consistent with those of the preceding period. When the auditor reports on two or more years, the auditor should evaluate whether the financial statements reported on are consistent with each other and with the prior year's financial statements, if presented. For example, assume that a company presents comparative financial statements covering three years and has a change in auditors. In the first year in which the successor auditor reports, the successor auditor evaluates consistency between the year on which he or she reports and the immediately preceding year. In the second year in which the successor auditor reports, the successor auditor would evaluate consistency between the two years on which he or she reports and between those years and the earliest year presented. In response to comments, the Board added this example to the final standard.

When a company uses retrospective application, as defined in SFAS No. 154, to account for a change in accounting principle, the financial statements presented generally will be consistent. However, the previous years' financial statements presented with the current year's financial statements will reflect the change in accounting principle and, therefore, will appear different from those previous years' financial statements on which the auditor previously reported. For example, consider a company that adopts a new accounting standard in 2007 that requires retrospective application to 2006 and 2005. The financial statements for 2006 and 2005 will be consistent, as presented with 2007. However, the financial statements for the years 2006 and 2005 that were issued a year earlier will not reflect the retrospective application and hence will not be consistent with 2007 and will be different from the 2006 and 2005 financial statements that are presented with 2007. The new standard clarifies that the auditor's evaluation of consistency should encompass previously issued financial statements for the relevant periods.

Paragraph 3 of the proposed standard described the financial statement periods covered by the evaluation of consistency. The third sentence of that paragraph was intended to be a clarification of the requirement in AU sec. 420.22 regarding the evaluation of two or more years. However, some commenters found the third sentence of paragraph 3 to be confusing and recommended retaining the language in AU sec. 420.22, unless the Board had intended to change the auditor's responsibilities for evaluating the consistency of GAAP. Because the Board wanted to be clear that the auditor's responsibilities had not changed, the Board decided to retain the original sentence from AU sec. 420.22, with some changes, instead of the proposed third sentence of paragraph 3. The inserted sentence, adapted from AU sec. 420.22, reads as follows (additions underlined and deletions struck through):

> When the ~~independent~~ auditor reports on two or more periods~~years~~, he or she should evaluate~~addressthe~~ consistency ~~of the application of accounting principles~~ between such periods~~years~~ and the consistency of such periods~~years~~ with the period~~year~~ prior thereto if such prior period~~year~~ is presented with the financial statements being reported upon.

The Board did not include the reference to "the application of accounting principles" because paragraph 3 also relates to the auditor's evaluation of a company's correction of a material misstatement, regardless of whether it involves the application of an accounting principle. The Board also used the word "evaluate"

because it describes the auditor's responsibilities consistently with the rest of the paragraph.

Two commenters suggested that the last sentence of proposed paragraph 3, which described the auditor's responsibility to evaluate whether the financial statements are consistent with previously issued financial statements for the same period, was confusing and unnecessary. These commenters suggested deleting the last sentence of paragraph 3. In addition, one commenter suggested that paragraph 3 of the proposed standard could be clarified by including the explanatory language from the proposing release regarding retrospective application under SFAS No. 154. As discussed above, the new standard is intended to clarify that the auditor's evaluation of consistency should include an evaluation of previously issued financial statements for the relevant periods. Accordingly, the Board believed that the final sentence of paragraph 3 is necessary. However, the Board agreed that including the suggested explanatory language from the proposing release regarding retrospective application would clarify the paragraph and has added that language as a footnote to paragraph 3.

3. Reference to Application of Accounting Principles

Consistent with the discussion above related to paragraph 3 of the proposed standard, the Board also removed the reference to "application of accounting principles" from the first paragraph of Auditing Standard No. 6. Because the auditor's evaluation of consistency under this standard includes errors not involving an accounting principle, the consistency evaluation is broader than that described under the second standard of reporting. Accordingly, the Board also removed the reference to the second standard of reporting from paragraph 2 of Auditing Standard No. 6.

4. Change in Accounting Principle

The new standard requires the auditor to evaluate a change in accounting principle[11] that has a material effect on the financial statements to determine whether: (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with GAAP, (3) the disclosures related to the accounting change are adequate, and (4) the company justifies that the alternative accounting principle is preferable,[12] as required by SFAS No. 154.[13] Under the amendments to AU sec. 508, if the four criteria are met,[14] the auditor would recognize the change in accounting principle in the auditor's report through the addition of an explanatory paragraph consisting of an identification of the nature of the change and a reference to the issuer's note disclosure describing the change.

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[11] The proposed and final standards use the definition of a change in accounting principle found in SFAS No. 154, paragraph 2c.

[12] In certain circumstances, Securities and Exchange Commission ("SEC") rules require issuers to file a letter from the auditor indicating whether or not a change is to an alternative accounting principle that is preferable. See Rule 10-01(b)(6) of Regulation S-X, 17 C.F.R. § 210.10-01(b)(6).

[13] Under SFAS No. 154, the issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle as long as the change in accounting principle is made in accordance with the GAAP hierarchy. See SFAS No. 154, paragraph 14.

[14] The auditor has substantially the same responsibility for evaluating a change in accounting principle as under AU sec. 431, *Adequacy of Disclosure in Financial Statements*, and paragraph .50 of AU sec. 508, *Reports on Audited Financial Statements*. The language in Auditing Standard No. 6 has, however, been updated to be consistent with SFAS No. 154.

If those criteria are not met, the auditor would issue a qualified or adverse opinion.[15]

Some commenters recommended that the Board reconsider whether it was necessary for the auditor to recognize in the audit report changes that result when a company is required to adopt a newly issued accounting standard. They indicated that the significance of a company's discretionary change in accounting principle may be diluted if the auditor recognizes both discretionary changes and those changes in accounting principles required by a newly-issued standard in the report. Another commenter suggested that the auditor should not be required to include an explanatory paragraph in the audit report when changes in accounting principle have been applied retrospectively because, in such cases, the financial statements included in the filing will appear consistent. As noted above, the Board believes that it is important for investors to be informed when the prior year financial statements presented with the current year are different from previously issued financial statements. In addition, the Board believes that the different language in the auditor's report for discretionary changes and those required by a newly-issued standard provides sufficient notification to investors of the general nature of the change. Therefore, the Board adopted the requirement as proposed.[16]

One commenter suggested that the proposed standard deleted useful information about a change in accounting principle that also involves a change in an estimate. The proposed standard did not carry forward the requirement of AU sec. 420.13 that the auditor should recognize in his or her report a change in accounting principle that is inseparable from a change in estimate. After considering this comment, the Board concluded that the requirement in AU sec. 420.13 does result in useful information being included in the auditor's report. Accordingly, the Board updated the language in AU sec. 420 to reflect the term used in SFAS 154, and included the requirement in Auditing Standard No. 6.[17]

Some commenters asked the Board to clarify the reporting requirement related to a change in reporting entity. According to AU sec. 420.08, a change in reporting entity resulting from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit, does not require that the auditor include an explanatory paragraph in the auditor's report. Under the proposed standard, the auditor may have been required to report on, for example, the disposition of a subsidiary or business unit because SFAS No. 154 (and its predecessor, APB Opinion No. 20) did not specifically exempt such a transaction from the definition of a change in reporting entity. Generally, dispositions or spin-offs have specific disclosure requirements in the accounting standards and the Board did not intend to change practice and require the auditor to report on these events through an explanatory paragraph. Accordingly, the Board carried forward the requirement from AU sec. 420.08 regarding a transaction or event. In addition, the Board also added a reference to paragraph 2f in SFAS No. 154, which describes a change in reporting entity, as suggested by some commenters.

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[15] This responsibility is substantially unchanged from AU sec. 508.51.

[16] In addition, one commenter suggested that the standard include an example of a change in the method of applying an accounting principle. The final standard, like the proposed standard, notes that under SFAS No. 154 a change in the method of applying an accounting principle is also a change in accounting principle. While the Board believes that it is helpful for the standard to reference the accounting requirement, it also believes that it is not appropriate for the auditing standard to provide accounting guidance.

[17] The new standard uses the term "change in accounting estimate effected by a change in accounting principle," which is defined in SFAS No. 154 as "a change in accounting estimate that is inseparable from the effect of a related change in accounting principle."

In response to comments, the Board also modified paragraph 8 of the proposed standard, which provided direction for reporting a change in accounting principle. Some commenters noted that the proposed conforming amendments to AU sec. 508.17 had a more clearly stated version of the number of years that the auditor is required to include an explanatory paragraph related to a change in principle than did footnote 5 to paragraph 8. After considering the commenters' recommendation that the language in the footnote be changed, the Board decided that the footnote was not necessary because paragraph 8 referred the auditor directly to the reporting requirements in AU sec. 508. The Board therefore removed footnote 5 from the final standard.

5. Correction of a Material Misstatement in Previously Issued Financial Statements

Under Auditing Standard No. 6, the correction of a material misstatement in previously issued financial statements (i.e., a "restatement") is recognized in the auditor's report through the addition of an explanatory paragraph. Under the conforming amendments to AU sec. 508, the explanatory paragraph in the auditor's report regarding a restatement should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. The first statement in the explanatory paragraph distinguishes restatements from adjustments to prior-period financial statements resulting from changes in accounting principle. Previously, the auditor's responsibilities for reporting on most restatements were the same as for reporting on changes in accounting principle.

One commenter suggested that the proposed standard did not clearly explain whether corrections of an error not involving a principle would require recognition in the auditor's report. Unlike the previous requirement, the proposed standard did not distinguish between the "correction of an error in principle" and an "error correction not involving a principle."[18] Rather, the proposed standard required recognition in the auditor's report of any correction of a material misstatement, whether or not the error involved a principle. The Board reconsidered the language and concluded that the requirement as proposed was sufficiently clear. The new standard aligns the auditor's reporting responsibilities with the accounting standards, which require disclosure of all restatements, by requiring an explanatory paragraph when the company has restated the financial statements.

Some commenters suggested that it would not improve clarity to have the auditor's report include a statement that the financial statements were restated "to correct a material misstatement." They noted that SFAS No. 154 already defines a restatement as the revision of previously issued financial statements to reflect the correction of an error. The Board decided to retain the reporting requirement as proposed because it clearly distinguishes corrections of misstatements from changes in accounting principle. Also, the required reporting language regarding restatements is more informative because it does not rely entirely on the user's knowledge of the definition of "restatement" in the accounting standard.[19]

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[18] This distinction previously was in paragraphs .12 and .16 of AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*.

[19] Two commenters suggested that the standard include the explanation from the release that the term "error," as used in SFAS No. 154, is equivalent to "misstatement," as used in the auditing standards. The Board agreed and has included that explanation in the final standard.

One commenter also recommended that the auditor's explanatory paragraph about the correction of a misstatement should contain additional information. The commenter recommended that the explanatory paragraph include a statement that (1) the previously issued auditor's report should not be relied on because the previously issued financial statements were materially misstated, and (2) the previously issued report is replaced by the auditor's report on the restated financial statements.

The Board believes that the recommended additional language is not necessary because existing PCAOB standards and rules of the Securities and Exchange Commission ("SEC") are sufficient to inform users about misstatements in previously issued financial statements. Specifically, AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, requires the auditor to take specific action when he or she concludes that information discovered after the financial statements have been issued would have affected his or her report if the company had not reflected the information in the financial statements and people are currently relying or are likely to rely on the financial statements and auditor's report. According to AU sec. 561.06, the auditor should advise the company to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently relying or who are likely to rely on the financial statements and the related auditor's report.[20]

A U.S. public company that is not a foreign private issuer under SEC rules also is required to file a Form 8-K current report, if it concludes that any previously issued financial statements should no longer be relied upon because of an error in such financial statements.[21] If the auditor has notified the issuer that action should be taken to prevent future reliance on a previously issued audit report, the company also must disclose that information in the Form 8-K.

6. Changes in Classification

Auditing Standard No. 6 does not require the auditor's report to recognize a change in classification[22] in previously issued financial statements, except for a reclassification that is also a change in accounting principle or correction of a material misstatement.[23] Accordingly, the new standard clarifies that the auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change is also a change in accounting principle or a correction of a material misstatement. For example, in some circumstances, a change in financial statement classification also may be the correction of a misstatement. A restatement to correct the misclassification of an account as short- or long-term or misclassification of cash flows would be

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[20] AU sec. 561.06 also requires that if the effect on the financial statements or auditor's report can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and auditor's report. If issuance of the financial statements with an auditor's report for a later period is imminent, a company is permitted to disclose the revision to the financial statements instead of reissuing earlier statements. When the effect on the financial statements cannot be determined without a prolonged investigation, appropriate disclosure would consist of notification that the financial statements and auditor's report should not be relied on and that revised financial statements and auditor's report will be issued upon completion of an investigation.

[21] See Securities Exchange Act Rule 13a-11, 17 C.F.R. § 240.13a-11.

[22] AU sec. 420.17 also did not require recognition of a change in financial statement classification in the auditor's report.

[23] SFAS No. 154 uses the term "presentation" in its definition of an error in previously issued financial statements. The directions in paragraph 11 of the new standard address the auditor's responsibilities for changes in classification, which is an element of the presentation and disclosure financial statement assertion under the auditing standards. See, e.g., paragraph .08 of AU sec. 326, *Evidential Matter*.

both a restatement and reclassification. Therefore, the auditor should evaluate these matters as part of the evaluation of corrections of misstatements. Under Auditing Standard No. 6, a classification change that is also a change in accounting principle should be reported on as a change in accounting principle, and a classification change that is also a correction of a material misstatement should be reported on by the auditor as a restatement.

Some commenters recommended slight revisions to the first sentence of paragraph 11 to clarify the auditor's responsibilities. The first sentence stated that changes in classification in previously issued financial statements do not require recognition in the auditor's report. This seemed to conflict with the second sentence which required the auditor to review a material change in classification and related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. The Board agreed with the comments and modified the first sentence to state that a change in classification does not require audit report recognition unless the change represents the correction of a material misstatement or a change in accounting principle. Additionally, in the proposed standard, the Board used the word "review" to describe the auditor's responsibility when there has been a material change in financial statement classification. The Board concluded that the word "evaluate" better describes the auditor's responsibilities in this area and is more consistent with the other requirements in Auditing Standard No. 6. Accordingly, the Board replaced "review" with "evaluate."

C. Description of GAAP and Removal of the GAAP Hierarchy from the Auditing Standards

As discussed previously, the FASB has proposed to incorporate the GAAP hierarchy into its own standards. The Board believes that it is appropriate to locate the GAAP hierarchy in the accounting standards rather than in the auditing standards. Thus, the Board amended its interim standards to remove the GAAP hierarchy from the auditing standards. These amendments do not change the principles in AU sec. 411 for evaluating fair presentation of the financial statements in conformity with GAAP.

Commenters strongly supported removing the GAAP hierarchy from the auditing standards and stated that it was appropriate for the GAAP hierarchy to be contained in the accounting standards. However, one commenter observed that the proposed amendments contain significant differences from the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's ("ASB") proposed amendment to AU sec. 411 of the ASB's standards.[24]

The Board believes that the amendments to AU sec. 411 are consistent with the Board's objective of removing the GAAP hierarchy from the auditing standards, and retaining, or providing, direction necessary for audits of public companies. The significant differences between the ASB's amendments to its AU sec. 411 and the Board's amendments primarily are related to sources of GAAP for governmental entities and direction on the application of accounting principles, which the Board did not believe was appropriate for inclusion in the proposed amendments. In addition, the Board deleted references to Rule 203

[24] In addition, this commenter suggested that U.S. auditing standard-setters should work together to achieve consistency on core auditing standards that are used by almost all auditors of U.S. entities. This commenter also suggested that if the Board continues issuing its own standards for audits of public companies, it should adopt alternative numbering/referencing schemes in order to reduce confusion between its interim standards and the AICPA standards. The Board is considering these comments as it seeks to make continuous improvements to its standard-setting and other programs.

of the AICPA's *Code of Professional Conduct*. Rule 203 prohibits auditors from expressing an opinion on financial statements that do not conform to GAAP unless the auditor can demonstrate that due to unusual circumstances the financial statements would have been misleading without departing from GAAP. In 2003, when the Board adopted certain AICPA rules and ASB standards as interim Board standards, the Board did not adopt Rule 203. Consistent with that action, the proposed amendments did not include a reference to Rule 203.

D. Section-by-Section Description of Amendments to the Interim Auditing Standards

In addition to proposing an auditing standard on evaluating consistency of financial statements, the Board also proposed amendments to other interim auditing standards and related interpretations. The following sections describe key aspects and elements of the amendments to the standards and interpretations, comments received, and changes incorporated in the final amendments.

AU sec. 410, Adherence to Generally Accepted Accounting Principles

The Board proposed to delete AU sec. 410.02 which discussed the meaning of "generally accepted accounting principles" and included other matters that are addressed elsewhere in the standards. However, some commenters suggested that, to improve clarity, AU sec. 410 should retain the sentence in existing AU sec. 410.02 which states that the "first standard is construed not to require a statement of fact by the auditor but an opinion."

The Board agreed that, when viewed alone, the first standard of reporting, contained in AU sec. 410.01, does not provide a complete description of the auditor's responsibilities related to fair presentation in conformity with GAAP. However, the first standard of reporting combined with the fourth standard clearly indicates that that the auditor is providing a statement of an opinion and not a statement of fact. The fourth standard of reporting provides that the auditor's report shall contain either an expression of opinion regarding the financial statements taken as a whole, or an assertion to the effect that an opinion cannot be expressed. To emphasize that the first and fourth reporting standards must be read together, the Board is including the fourth standard of reporting in the final amendment to AU sec. 410. However, as proposed, the prior statement on the meaning of "generally accepted accounting principles" has been deleted from AU sec. 410.02.

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

The Board proposed to delete AU sec. 411.02, which was a detailed description of GAAP, and AU secs. 411.05, .07 and .09-.15, which described the application of the GAAP hierarchy. The Board proposed to replace the description of GAAP in AU 411.02, with a statement that GAAP refers "to the accounting principles recognized in the standards of the Financial Accounting Standards Board or in the standards of any other standard-setting body recognized by the U.S. Securities and Exchange Commission."

However, commenters had concerns about the proposal. One commenter noted that the SEC might allow companies to file financial statement prepared in conformity with international financial reporting standards ("IFRS") but not recognize the International Accounting Standards Board, which issues IFRS, as a standard-setting body. Another commenter suggested that to avoid potential

confusion by users, the Board should acknowledge that there are other sources of GAAP for entities other than public companies.

In response to these comments, the Board decided to modify its proposed amendment of AU 411. It deleted AU sec. 411.02, which described GAAP, and revised AU sec. 411.01 to indicate that the auditor should look to the requirements of the SEC for the company under audit to identify the accounting principles that are applicable to that company. This change should also clarify that the standard is focused only on the accounting principles that may be used for purposes of the federal securities laws. Other accounting principles may apply to financial statements prepared for other purposes or by entities that are not issuers. The Board also modified AU 411.01 to better emphasize that standard's focus on the meaning of the phrase "present fairly."

Finally, as proposed, the Board eliminated AU secs. 411.16 and .17 which set an effective date and transition requirements that are no longer applicable.

AU sec. 420, Consistency of Application of Generally Accepted Accounting Principles

AU sec. 420 has been superseded by Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*. However, some commenters suggested that parts of AU sec. 420 should have been incorporated into Auditing Standard No. 6. Commenters suggested that guidance on the objective of the consistency standard and the relationship of consistency and comparability, matters that may not affect consistency, and changes expected to have a material future effect provided useful direction.

The Board believes that it is unnecessary to include the preceding direction. The proposed standard clarified that the auditor's report should recognize only those matters that require recognition under the existing auditing standards—i.e., a change in accounting principle or the correction of a material misstatement. The Board does not believe it is necessary to list in a standard those matters that do not require recognition in the auditor's report. Also, the Board believes that paragraph 1 clearly describes the objective of the standard. Paragraph 2 makes it clear that the standard considers comparability to be between periods for the company under audit.

AU sec. 431, Adequacy of Disclosure in Financial Statements

AU sec. 431 describes the auditor's responsibilities for evaluating the adequacy of disclosures in the financial statements. The amendments address two technical matters relating to that section.

Footnote 1 to AU sec. 431.03 is not consistent with the SEC's independence rules regarding non-audit services and therefore has been eliminated.

AU sec. 431.04 is an application of the AICPA's *Code of Professional Conduct* regarding the disclosure of confidential client information. In 2003, when the Board adopted certain AICPA rules and ASB standards as interim Board standards, the Board did not adopt Rule 301. Consistent with that action, the proposed amendments would eliminate AU sec. 431.04.

Some commenters expressed concerns that the proposed elimination of AU sec. 431.04 would change the auditor's obligations, or reflected Board policy, regarding the use of confidential client information in connection with evaluating the adequacy of financial statement disclosures. Those commenters generally recognized the limited nature of AU sec. 431.04 and acknowledged that, since in 2003 the Board did not adopt Rule 301, removing a portion of the interim standards based on that rule was a conforming amendment. However,

they were concerned that the Board's action might be construed as minimizing the auditor's responsibilities for maintaining the confidentiality of client information.

The Board is aware that many auditors have legal or professional obligations to maintain the confidentiality of client information. These requirements arise from the rules of state licensing authorities,[25] the rules of professional organizations such as the AICPA and the International Federation of Accountants, and the laws of some foreign jurisdictions. The Board's decision to omit Rule 301 from its interim standards was based on a determination that incorporation of that rule was not necessary to fulfill the Board's mandate under Section 103(a)(1) and (3) of the Sarbanes-Oxley Act. It did not reflect a decision that auditor confidentiality requirements imposed by other authorities were inappropriate. Similarly, in amending AU sec. 431, the Board seeks neither to modify nor to detract from existing confidentiality requirements.

Interpretations of the Auditing Standards in AU 400 Sections

The auditing interpretation in AU sec. 9420.52-.54 has been incorporated into Auditing Standard No. 6 and therefore has been eliminated, as proposed. The auditing interpretations in AU sec. 9411 and the remaining auditing interpretations in AU sec. 9420 are addressed by the accounting standards and therefore also have been eliminated as proposed.[26]

AU sec. 508, Reports on Audited Financial Statements

In general, the Board has adopted the amendments as proposed. The amendments have conformed this interim auditing standard to Auditing Standard No. 6 on evaluating consistency and the amendments to AU secs. 410 and 411, described above. For example, AU sec. 508.16 now specifically identifies the matters related to consistency of the company's financial statements that should be recognized in the auditor's report. Similarly, AU sec. 508.17A provides the requirements for evaluating consistency, that also is in paragraph 7 of Auditing Standard No. 6. AU secs. 508.17B and C, and AU sec. 508.18A provide separate requirements for reporting on changes in accounting principles and restatements, as discussed previously.

In addition, the amendments eliminate AU sec. 508.14-.15. Those paragraphs were an application of AICPA Ethics Rule 203, which, as previously noted, was not adopted as an interim standard by the Board.[27]

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[25] For example, confidentiality requirements are included in the provisions of the Uniform Accountancy Act, which has been enacted in some form by many states.

[26] One commenter suggested that some of the auditing interpretations should be retained because the guidance is still relevant. The Board considered the view of this commenter but decided to eliminate the interpretations because other auditing standards provided the necessary direction regarding the matter addressed in the interpretation, the interpretation dealt with items not requiring recognition in the auditor's report, or the interpretation was related to an accounting consideration of the company.

[27] One commenter expressed concern about deleting these paragraphs and suggested that, if the Board's intent was to delete all reference to the AICPA Code of Professional Conduct from the Board's interim standards, the Board should indicate the professional ethics that auditors should follow when conducting audits according to PCAOB standards. The Board's Rules 3500T and 3600T describe the Board's interim ethics and independence standards, respectively. These standards include certain provisions from the AICPA's Code of Professional Conduct. In addition, the Board has adopted ethics and independence rules concerning independence, tax services, and contingent fees. See PCAOB Release No. 2005-014 (July 26, 2005). State law and membership organizations may impose additional requirements.

Finally, in light of the definitions in SFAS No. 154, the amendments change references to "restatements" to the more general term "adjustments" to refer broadly to changes to previously issued financial statements that may result from either a correction of a misstatement or a change in accounting principle.[28]

References to APB Opinion No. 20

In addition, the Board has adopted other amendments to update references to APB Opinion No. 20, which was superseded by SFAS No. 154. Accordingly the Board amended AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, footnote 3 to paragraph .06, to reference paragraphs 25 and 26 of SFAS No. 154. For AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, footnote 4 to paragraph .19, the Board referenced paragraph 20 of SFAS No. 157, *Fair Value Measurements*, which states that a change in valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. This replaces a reference to the preferability requirement in SFAS No. 157 because that requirement does not apply to a change in a company's method for determining fair value. Paragraph 20 is the accounting guidance applicable to a company's change in method for determining fair value.

E. Effective Date

This standard and amendments will be effective 60 days after approval by the SEC.

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On the 29th day of January, in the year 2008, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Secretary

January 29, 2008

APPENDICES—

1. Auditing Standard No. 6—*Evaluating Consistency of Financial Statements*
2. Amendments to Interim Auditing Standards

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[28] Some commenters suggested that certain other changes were needed to AU sec. 508 or that certain amendments were not necessary. For example, some commenters suggested eliminating AU sec. 508.57 and retaining the original terminology in AU secs. 508.73-.74. The Board decided that some of the suggested changes would change existing practice, such as the elimination of AU sec. 508.57, and were outside the scope of this project. For the others, the Board concluded that the amendments were consistent with the direction in Auditing Standard No. 6. In addition, one commenter believed that there were inconsistencies between the proposed amendments to AU sec. 508 and Staff Questions and Answers, *Adjustments to Prior-Period Financial Statements Audited By a Predecessor Auditor*. However, the Board reviewed the Staff Questions and Answers and did not agree that there were inconsistencies with the proposed amendments to AU sec. 508.

Appendix 1

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

[Appendix omitted; see Auditing Standard No. 6 for the full text of the standard.]

Appendix 2

Amendments to Interim Auditing Standards

[Appendix omitted; see appendix 2 in PCAOB Release No. 2008-001 for a list of the amendments.]

Auditing Standard No. 7
Engagement Quality Review

[Supersedes SECPS Requirements of Membership §1000.08(f).]

Source: Auditing Standard Nos. 8–15.

Applicability of Standard

1. An engagement quality review and concurring approval of issuance are required for each audit engagement and for each engagement to review interim financial information conducted pursuant to the standards of the Public Company Accounting Oversight Board ("PCAOB").

Objective

2. The objective of the engagement quality reviewer is to perform an evaluation of the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report, if a report is to be issued, in order to determine whether to provide concurring approval of issuance.[1]

Qualifications of an Engagement Quality Reviewer

3. The engagement quality reviewer must be an associated person of a registered public accounting firm. An engagement quality reviewer from the firm that issues the engagement report (or communicates an engagement conclusion, if no report is issued) must be a partner or another individual in an equivalent position. The engagement quality reviewer may also be an individual from outside the firm.[2]

4. As described below, an engagement quality reviewer must have competence, independence, integrity, and objectivity.

> Note: The firm's quality control policies and procedures should include provisions to provide the firm with reasonable assurance that the engagement quality reviewer has sufficient competence, independence, integrity, and objectivity to perform the engagement quality review in accordance with the standards of the PCAOB.

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[1] In the context of an audit, "engagement report" refers to the audit report (or reports if, in an integrated audit, the auditor issues separate reports on the financial statements and internal control over financial reporting). In the context of an engagement to review interim financial information, the term refers to the report on interim financial information. An engagement report might not be issued in connection with a review of interim financial information. See paragraph .03 of AU section ("sec.") 722, *Interim Financial Information*.

[2] An outside reviewer who is not already associated with a registered public accounting firm would become associated with the firm issuing the report if *he or she* (rather than, or in addition to, his or her firm or other employer): (1) receives compensation from the firm issuing the report for performing the review or (2) performs the review as agent for the firm issuing the report. See PCAOB Rule 1001(p)(i) for the definition of an associated person of a registered public accounting firm.

Competence

5. The engagement quality reviewer must possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the engagement partner on the engagement under review.[3]

Independence, Integrity, and Objectivity

6. The engagement quality reviewer must be independent of the company, perform the engagement quality review with integrity, and maintain objectivity in performing the review.

> Note: The reviewer may use assistants in performing the engagement quality review. Personnel assisting the engagement quality reviewer also must be independent, perform the assigned procedures with integrity, and maintain objectivity in performing the review.

7. To maintain objectivity, the engagement quality reviewer and others who assist the reviewer should not make decisions on behalf of the engagement team or assume any of the responsibilities of the engagement team. The engagement partner remains responsible for the engagement and its performance, notwithstanding the involvement of the engagement quality reviewer and others who assist the reviewer.

8. The person who served as the engagement partner during either of the two audits preceding the audit subject to the engagement quality review may not be the engagement quality reviewer. Registered firms that qualify for the exemption under Rule 2-01(c)(6)(ii) of Regulation S-X, 17 C.F.R. 210.2-01(c)(6)(ii), are exempt from the requirement in this paragraph.

Engagement Quality Review for an Audit

Engagement Quality Review Process

9. In an audit engagement, the engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report. To evaluate such judgments and conclusions, the engagement quality reviewer should, to the extent necessary to satisfy the requirements of paragraphs 10 and 11: (1) hold discussions with the engagement partner and other members of the engagement team, and (2) review documentation.

10. *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

In an audit, the engagement quality reviewer should:

a. Evaluate the significant judgments that relate to engagement planning, including—

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[3] 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. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

— The consideration of the firm's recent engagement experience with the company and risks identified in connection with the firm's client acceptance and retention process,

— The consideration of the company's business, recent significant activities, and related financial reporting issues and risks, and

— The judgments made about materiality and the effect of those judgments on the engagement strategy.

b. Evaluate the engagement team's assessment of, and audit responses to—

— Significant risks identified by the engagement team, including fraud risks, and

— Other significant risks identified by the engagement quality reviewer through performance of the procedures required by this standard.

Note: A *significant risk* is a risk of material misstatement that requires special audit consideration.

c. Evaluate the significant judgments made about (1) the materiality and disposition of corrected and uncorrected identified misstatements and (2) the severity and disposition of identified control deficiencies.

d. Review the engagement team's evaluation of the firm's independence in relation to the engagement.

e. Review the engagement completion document[4] and confirm with the engagement partner that there are no significant unresolved matters.

f. Review the financial statements, management's report on internal control, and the related engagement report.

g. Read other information in documents containing the financial statements to be filed with the Securities and Exchange Commission ("SEC")[5] and evaluate whether the engagement team has taken appropriate action with respect to any material inconsistencies with the financial statements or material misstatements of fact of which the engagement quality reviewer is aware.

h. Based on the procedures required by this standard, evaluate whether appropriate consultations have taken place on difficult or contentious matters. Review the documentation, including conclusions, of such consultations.

i. Based on the procedures required by this standard, evaluate whether appropriate matters have been communicated, or identified for communication, to the audit committee, management, and other parties, such as regulatory bodies.

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[4] Paragraph 13 of PCAOB Auditing Standard No. 3, *Audit Documentation*, requires the auditor to identify all significant findings or issues in an engagement completion document.

[5] See paragraphs .04–.06 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*; AU sec. 711, *Filings Under Federal Securities Statutes*.

Evaluation of Engagement Documentation

11. In an audit, the engagement quality reviewer should evaluate whether the engagement documentation that he or she reviewed when performing the procedures required by paragraph 10—

a. Indicates that the engagement team responded appropriately to significant risks, and

b. Supports the conclusions reached by the engagement team with respect to the matters reviewed.

Concurring Approval of Issuance

12. In an audit, the engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care[6] the review required by this standard, he or she is not aware of a significant engagement deficiency.

Note: A *significant engagement deficiency* in an audit exists when (1) the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.

13. In an audit, the firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance.[7]

Engagement Quality Review for a Review of Interim Financial Information

Engagement Quality Review Process

14. In an engagement to review interim financial information, the engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report, if a report is to be issued. To evaluate such judgments and conclusions, the engagement quality reviewer should, to the extent necessary to satisfy the requirements of paragraphs 15 and 16: (1) hold discussions with the engagement partner and other members of the engagement team, and (2) review documentation.

15. In a review of interim financial information, the engagement quality reviewer should:

a. Evaluate the significant judgments that relate to engagement planning, including the consideration of—

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[6] See AU sec. 230, *Due Professional Care in the Performance of Work*.

[7] Concurring approval of issuance by the engagement quality reviewer also is required when reissuance of an engagement report requires the auditor to update his or her procedures for subsequent events. In that case, the engagement quality reviewer should update the engagement quality review by addressing those matters related to the subsequent events procedures.

— The firm's recent engagement experience with the company and risks identified in connection with the firm's client acceptance and retention process,

— The company's business, recent significant activities, and related financial reporting issues and risks, and

— The nature of identified risks of material misstatement due to fraud.

b. Evaluate the significant judgments made about (1) the materiality and disposition of corrected and uncorrected identified misstatements and (2) any material modifications that should be made to the disclosures about changes in internal control over financial reporting.

c. Perform the procedures described in paragraphs 10.d and 10.e.

d. Review the interim financial information for all periods presented and for the immediately preceding interim period, management's disclosure for the period under review, if any, about changes in internal control over financial reporting, and the related engagement report, if a report is to be issued.

e. Read other information in documents containing interim financial information to be filed with the SEC[8] and evaluate whether the engagement team has taken appropriate action with respect to material inconsistencies with the interim financial information or material misstatements of fact of which the engagement quality reviewer is aware.

f. Perform the procedures in paragraphs 10.h and 10.i

Evaluation of Engagement Documentation

16. In a review of interim financial information, the engagement quality reviewer should evaluate whether the engagement documentation that he or she reviewed when performing the procedures required by paragraph 15 supports the conclusions reached by the engagement team with respect to the matters reviewed.

Concurring Approval of Issuance

17. In a review of interim financial information, the engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care the review required by this standard, he or she is not aware of a significant engagement deficiency.

Note: A *significant engagement deficiency* in a review of interim financial information exists when (1) the engagement team failed to perform interim review procedures necessary in the circumstances of the engagement, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.

18. In a review of interim financial information, the firm may grant permission to the client to use the engagement report (or communicate an engagement

[8] See AU sec. 722.18f; AU sec. 711.

conclusion to its client, if no report is issued) only after the engagement quality reviewer provides concurring approval of issuance.

Documentation of an Engagement Quality Review

19. Documentation of an engagement quality review should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of this standard, including information that identifies:

a. The engagement quality reviewer, and others who assisted the reviewer,

b. The documents reviewed by the engagement quality reviewer, and others who assisted the reviewer,

c. The date the engagement quality reviewer provided concurring approval of issuance or, if no concurring approval of issuance was provided, the reasons for not providing the approval.

20. Documentation of an engagement quality review should be included in the engagement documentation.

21. The requirements related to retention of and subsequent changes to audit documentation in PCAOB Auditing Standard No. 3, *Audit Documentation*, apply with respect to the documentation of the engagement quality review.

Attachment

PCAOB Release No. 2009-004

July 28, 2009

PCAOB Rulemaking
Docket Matter No. 025

Summary

After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") is adopting an auditing standard, *Engagement Quality Review*, that will be applicable to all registered firms and will supersede the Board's interim concurring partner review requirement, and a conforming amendment to the Board's interim quality control standards.

Board Contacts

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I. Introduction

Section 103 of the Sarbanes-Oxley Act (the "Act") directs the Board, among other things, to set standards for public company audits, including a requirement or each registered public accounting firm to "provide a concurring or second partner review and approval of [each] audit report (and other related information), and concurring approval in its issuance . . . ." A well-performed engagement quality review ("EQR") can serve as an important safeguard against erroneous or insufficiently supported audit opinions and, accordingly, can contribute to audit quality. In February 2008, the Board proposed to replace its interim requirement with a new EQR standard.[1] The Board's original proposal was developed in response, among other things, to feedback from some members of its Standing Advisory Group ("SAG") that the existing interim requirements[2] (the "existing requirements") do not provide for a sufficiently thorough review to give investors assurance on the quality of engagements. The proposal was intended to enhance the quality of the EQR by strengthening the existing requirements.

Commenters recommended significant modifications to the original proposal, and, in response, the Board made changes designed to better tailor the standard to its purposes.[3] Because of the extent of those changes, the Board again sought public comment, this time on the standard as revised. The Board has considered

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[1] PCAOB Release No. 2008-002, Proposed Auditing Standard—*Engagement Quality Review and Conforming Amendment to the Board's Interim Quality Control Standards* (February 26, 2008) (the "original proposal").

[2] The Securities and Exchange Commission Practice Section ("SECPS") of the American Institute of Certified Public Accountants ("AICPA") Requirements of Membership Sections 1000.08(f); 1000.39, Appendix E.

[3] Comments on the original proposal and the Board's responses are described in PCAOB Release No. 2009-001, Proposed Auditing Standard—*Engagement Quality Review* (March 4, 2009) (the "reproposing release").

those comments, as well as the input of the SAG, and the final standard ("AS No. 7" or the "EQR standard") has benefitted from the additional public input.[4]

The EQR standard the Board is adopting provides for a rigorous review that will serve as a meaningful check on the work performed by the engagement team. AS No. 7 should increase the likelihood that a registered public accounting firm will catch any significant engagement deficiencies before it issues its audit report. As a result, the Board recognizes that more work may be necessary under the EQR standard than was performed in some concurring reviews under the existing requirements.

At the same time, the Board has been sensitive to commenters' concerns and agrees that the EQR should not become, in effect, a second audit. Instead, the EQR should be—and, as described in AS No. 7, is—a review of work already performed by the engagement team. The EQR standard requires the engagement quality reviewer (or the "reviewer") to evaluate the significant judgments made and related conclusions reached by the engagement team in forming the overall conclusion on the engagement and in preparing the engagement report, and requires certain procedures designed to focus the reviewer on those judgments and conclusions.

The procedures required of the reviewer by AS No. 7 are different in nature from the procedures required of the engagement team. Unlike the engagement team, a reviewer does not perform substantive procedures or obtain sufficient evidence to support an opinion on the financial statements or internal control over financial reporting. If more audit work is necessary before the reviewer may provide concurring approval of issuance, the engagement team—not the reviewer—is responsible under PCAOB standards for performing the work. In contrast, the reviewer fulfills his or her responsibility to perform an effective review of the engagement under the EQR standard by holding discussions with the engagement team, reviewing documentation, and determining whether he or she can provide concurring approval of issuance.

II. Overview of Auditing Standard No. 7

Overall, commenters preferred the reproposed standard to the original proposal, though some continued to believe that certain provisions were unclear and suggested certain changes to the standard. After considering commenters' feedback, the Board has made several modifications to the EQR standard to provide additional clarity. This section describes the comments received, the Board's response, and changes made in AS No. 7.[5]

A. Applicability of the EQR Requirement

Paragraph 1 of the reproposed standard required an EQR for audit engagements and reviews of interim financial information ("interim reviews"), but not for other engagements performed according to the standards of the PCAOB. For

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[4] The Board received 38 comments on the original proposal and 30 comments on the reproposal. The SAG discussed the reproposed standard on April 2, 2009. A transcript of that discussion is available on the Board's website at http://pcaobus.org/Rules/Rulemaking/Docket%20025/2009-04-02_EQR_SAG_Transcript.pdf. The SAG also discussed EQR on June 22, 2004 and October 5, 2005. Archived webcasts are available on the Board's website at http://pcaobus.org/News/Webcasts/Pages/default.aspx.

[5] The Board received some comments related to its standard-setting process in general. The Board continuously endeavors to improve its processes, including its standard-setting process, and is considering these comments as it does so.

the most part, commenters believed that this provision was appropriate.[6] One commenter, however, suggested including the EQR requirements for interim reviews in AU section ("sec.") 722, *Interim Financial Information*, instead of including them as part of the EQR standard to "make it clear that the scope of the procedures performed remain under the umbrella of the objective of a review of interim financial information (which is much different than the scope and objective of an audit)." Because the requirements for the EQR of interim reviews in AS No. 7 are closely related to and described by reference to the requirements for the EQR of an audit, the Board believes it is more appropriate to locate both sets of requirements in the same standard. Accordingly, the Board is adopting the provisions regarding applicability of the EQR standard as reproposed.

B. Statement of Objective

The reproposed standard included a statement of objective intended to focus reviewers on the overall purpose of the standard as they carry out the more specific EQR requirements. As reproposed, the objective of the engagement quality reviewer was "to perform an evaluation of the significant judgments made by the engagement team and the conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report, if a report is to be issued, in order to determine whether to provide concurring approval of issuance."

Most commenters agreed that the EQR standard should include a statement of objective. While some believed the objective was appropriate as reproposed, several suggested substituting the phrase "related conclusions reached" for "the conclusions reached" to indicate that the reviewer is required to evaluate conclusions relating to significant judgments, rather than all conclusions. In addition, some commenters suggested making the objective less vague, while others wanted the Board to broaden it or make it less procedural.

After considering these comments, the Board has, as suggested by commenters, revised the objective so that it refers to "significant judgments made by the engagement team[7] and the *related* conclusions reached. . . ." (emphasis added). This change should help reviewers maintain their focus on areas of the engagement that are most likely to contain a significant engagement deficiency. With this revision, the Board believes the statement of objective establishes, at the appropriate level of detail, a framework for the performance of the EQR that is consistent with the specific requirements in AS No. 7. Corresponding changes have been made in paragraphs 9 and 14, which describe the scope of the EQR for audits and interim reviews, respectively. The reviewer achieves his or her objective by complying with the specific requirements of the standard.

C. Qualifications of the Engagement Quality Reviewer

In order to provide for a high-quality EQR, the reproposed standard described the qualifications that any reviewer would be required to meet. These provisions

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[6] One commenter did not believe that an EQR should be required for interim reviews because of concerns about the scope of the EQR for interim reviews. The section entitled *Specifically Required Procedures in the EQR of an Interim Review* of this release discusses the EQR requirements for interim reviews.

[7] Because the engagement partner has final responsibility for the engagement, he or she has final responsibility for the significant judgments made during the engagement, notwithstanding any involvement in or responsibility for those judgments by firm personnel outside of the engagement team, such as members of the firm's national office. Accordingly the "significant judgments made by the engagement team" include all of the significant judgments made during the engagement.

were designed to provide assurance that the reviewer could effectively perform an EQR of the particular engagement under review. At the same time, the provisions recognized that smaller firms may have few partners—and, in the case of sole practitioners, no additional partners—available in-house to perform the EQR.

Accordingly, the reproposed standard required an engagement quality reviewer from within the firm issuing the engagement report to be a partner or another individual in an equivalent position, but also allowed a qualified individual from outside the firm to perform the EQR. In either event, the reproposed standard required the reviewer to be an associated person[8] of a registered public accounting firm.[9] The reproposed standard also included a general competence requirement and requirements related to the reviewer's independence, integrity, and objectivity.

In-House Reviewer: Partner or an Individual in an Equivalent Position

The requirement in the reproposed standard for a reviewer from within the firm to be a partner or an individual in an equivalent position was intended to address concerns expressed by some commenters on the original proposal about the authority of the engagement quality reviewer relative to that of the engagement partner. Because the EQR is intended to be an objective second look at work performed by the engagement team, the reviewer should be able to withstand pressure from the engagement partner or other firm personnel, such as members of the firm's national office. As described in the reproposing release, the Board believed that concerns about authority will most often arise when the reviewer and the engagement partner work at the same firm. The Board also believed that a standard based on perceptions of relative authority within a firm would not be sufficiently clear to be workable. Accordingly, the Board attempted to address these concerns with a requirement that an in-house reviewer—but not one from outside the firm—be a partner or person in an equivalent position.

While some commenters supported the reproposed requirement, others disagreed with it, generally because, in their view, being a partner or person in an equivalent position would not necessarily ensure that the reviewer possesses the qualities required to perform the EQR. These commenters noted that partners as well as non-partners may be subject to internal pressure within the firm to provide concurring approval of issuance. In addition, in one commenter's view, it would be burdensome for one-partner firms to hire an outside reviewer to comply with this requirement. Finally, some commenters also asked the Board to define the term "equivalent position."

While both partners and non-partners may experience pressure within the firm to provide concurring approval of issuance, the Board continues to believe that

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[8] For clarity, in paragraph 3 of AS No. 7, the Board added a reference to Rule 1001(p)(i), which defines the term "associated person of a registered public accounting firm." A person not already associated with a registered firm can enter into a relationship with the firm issuing the report such that the person would become associated with that firm by performing the review. Specifically, a person not already associated with a firm would become associated with the firm issuing the report if *he or she* (rather than, or in addition to, his or her firm or other employer): (1) receives compensation from the firm issuing the report for performing the review or (2) performs the review as agent for the firm issuing the report. For example, if the firm issuing the report contracts directly with an employee of an unregistered accounting firm to perform the engagement quality review, that person would become associated with the firm issuing the report by virtue of that independent contractor relationship.

[9] A registered public accounting firm has an obligation to secure and enforce consents to cooperate with the Board from each associated person of the firm, see Section 102(b)(3) of the Act, including those who become associated with the firm by performing the review. The Board also may directly sanction any such person who fails to cooperate in an investigation or inspection. See Section 105(b)(3) of the Act and PCAOB Rules 5110 and 4006.

the reproposed requirement is the most appropriate way to address this issue. Partnership is not a perfect proxy for authority, but a partner is more likely to possess sufficient authority to conduct the EQR than a non-partner. The Board continues to believe that a requirement based on perceptions of authority would not be workable. Accordingly, the Board is adopting this requirement substantially as reproposed.[10] At a firm that is not organized as a partnership, "an individual in an equivalent position" is someone with the degree of authority and responsibility of a partner in a firm that is organized as a partnership.

Qualified Reviewer from Outside the Firm

As noted above, the reproposed standard also allowed a qualified reviewer from outside the firm to conduct the review. In the reproposing release, the Board expressed the view that allowing a sufficiently qualified professor or other individual not employed by an accounting firm to perform the EQR should not negatively affect audit quality and may mitigate the compliance burden on sole practitioners and smaller firms. The Board sought comment on whether a qualified accountant who is not employed by an accounting firm should be allowed to conduct the EQR.[11]

The majority of commenters on this topic did not oppose the reproposed provision. Some commenters, however, cautioned that reviewers from outside an accounting firm may not necessarily have the required technical expertise or recent audit experience. One commenter believed that allowing the use of such outside reviewers could "hamper the existing independence rules,"[12] increase costs, and limit the potential growth of partners.

After considering these comments, the Board continues to believe that the EQR standard can—and should—allow firms the proposed flexibility in choosing a reviewer, provided that reviewer meets the competence and other qualification requirements. According to these requirements, as discussed below, any reviewer would have to have the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the person who has overall responsibility for the engagement under review. Accordingly, while some persons from outside a firm might not have the required qualifications, those who do can effectively perform the EQR.[13]

The Board also does not agree that allowing the use of a reviewer from outside the firm issuing the report would negatively affect the application or enforcement of the independence rules. As the Board noted in the reproposing release, it will continue to consider anyone who performs the EQR to be an "audit partner" and a member of the "audit engagement team" for purposes of independence requirements.[14] In addition, because AS No. 7 would not require a firm to use an outside reviewer, allowing a firm to do so should not increase costs or limit the potential growth of partners. Any firm that is concerned that invoking the

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[10] One commenter suggested that the phrasing of the reproposed standard did not establish a requirement for the in-house reviewer to be a partner because it stated that the reviewer "may be" a partner, a person in an equivalent position, or an individual outside the firm. While the use of "may" in that context imposed a requirement, to avoid any confusion on this point the Board has rephrased the requirement in paragraph 3 of AS No. 7 to use the word "must."

[11] As noted in the reproposing release, under the existing requirement a firm may seek a waiver to engage an outside experienced individual to perform the EQR. Because AS No. 7 allows a firm to use an outside reviewer, such a waiver is not necessary under AS No. 7.

[12] The comment did not explain how the independence rules would be hampered.

[13] Similarly, a reviewer does not meet all of the qualification requirements in AS No. 7 by virtue of his or her status as a partner or employee of an accounting firm.

[14] See Rule 2-01(f) of Regulation S-X, 17 C.F.R. 210.2-01(f), for the definitions of "audit partner" and "audit engagement team."

flexibility provided by the EQR standard would raise its costs or impede the development of its partners could, simply, decline to do so and use a reviewer from within the firm if one is available.

When considering an outside individual for the role of the engagement quality reviewer, the firm will likely need to make additional inquiries to obtain necessary information about the individual's qualifications. For example, while information about independence of the firm's partners is typically collected and evaluated as part of the periodic independence review, information about the independence of an outside reviewer will likely need to be requested and evaluated as part of the reviewer selection process. Firms also likely know more about the competence of their own partners than of an outside reviewer.

General Competence Requirement

As noted above, the reproposed standard, like the original proposal, included a requirement for the reviewer to "possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the person who has overall responsibility for the same type of engagement." This provision was intended to set a minimum requirement for those who would perform the EQR. In response to comments on the original proposal, the reproposing release explained that this provision, by its terms, did not require the engagement quality reviewer's knowledge and competence to match those of the engagement partner, or for the reviewer to be a "clone" of the engagement partner.[15]

Some commenters reiterated their concerns that the engagement quality reviewer's skills would be expected to match those of the engagement partner, and that such a requirement could cause resource constraints for smaller firms. Other commenters suggested modifying the general competence provision by stating that the reviewer's competence should be established based on the facts and circumstances of the engagement, or describing the required qualifications from the reviewer's perspective, rather than by comparing them to the qualifications of the engagement partner. Finally, some commenters suggested including in the EQR standard a statement that the reviewer may obtain the required level of knowledge and competence through utilizing assistants.

The Board continues to believe that if a minimum level of knowledge and competence in accounting, auditing, and financial reporting is required to conduct an audit, it is similarly necessary to effectively review that audit.[16] The reviewer is not required to possess other competencies, e.g., those related to communication or management skills, that the engagement partner may have.

Accordingly, the Board is adopting the general competence provision substantially as proposed. The Board is, however, modifying the requirement to clarify further that the determination of what constitutes the appropriate level of knowledge and competence should be based on the circumstances of the engagement, including the size and complexity of the business under audit or under interim review.[17] In AS No. 7, the Board replaced the phrase "the same type of

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[15] Specifically, the reproposing release noted:

> The general competence provision merely sets a minimum requirement for those who would perform the EQR, but it does not require the reviewer's competence to match that of the engagement partner. In many cases, both individuals' competence will exceed the minimum level prescribed, but there is no requirement that they do so in tandem, or even at all.

[16] While a reviewer may use assistants in performing the EQR, the reviewer's own skills should meet the requirements of AS No. 7.

[17] Footnote 18 on page 9 of the original release stated, "The determination of what constitutes the appropriate level of knowledge and competence should be based on the circumstances of the engagement, including the size or complexity of the business."

engagement" with "the engagement." The new phrasing focuses the reviewer on the particular engagement under review, rather than that "type" of engagement.[18] Firms that do not have partners that meet this general competence requirement available to perform the EQR may engage an outside reviewer to perform an EQR.

Independence, Integrity, and Objectivity

Like the original proposal, the reproposed standard required the reviewer to be independent of the company, perform the review with integrity, and maintain objectivity. Comments on the reproposal focused on two provisions regarding objectivity—the prohibition against the reviewer supervising the engagement team and the two-year "cooling-off" period before the engagement partner could perform the EQR.

Supervision of the Engagement Team

The reproposed standard provided that to maintain objectivity the engagement quality reviewer should not, among other things, "supervise the engagement team with respect to the engagement subject to the engagement quality review." The phrase "subject to the engagement quality review" was intended to clarify that partners with leadership responsibilities in a firm, region, service, or industry practice are not, solely because of those responsibilities, precluded from reviewing any engagement performed by their subordinates in the firm. Some commenters believed that the phrase "subject to the engagement quality review" was not sufficient to clarify this point.

After considering these comments, the Board has decided that the express prohibition against "supervis[ing] the engagement team with respect to the engagement subject to the engagement quality review" is not necessary to effectuate the Board's intent. The remaining two criteria for maintaining objectivity in paragraph 7 of AS No. 7—not making decisions on behalf of the engagement team and not assuming any responsibilities of the engagement team—are sufficient to preclude those involved in the engagement from serving as the engagement quality reviewer.[19] For example, partners (including the engagement partner and other partners on larger engagements), managers, and others who supervise engagement personnel on the audit under review would not qualify under the remaining criteria because they have assumed responsibilities of the engagement team. At the same time, removing the phrase "supervise the engagement team" from AS No. 7 should further clarify that those in leadership positions in the firm who did not make decisions for or assume responsibilities of the engagement team may perform the EQR.

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[18] In addition, to simplify the text of AS No. 7, the Board replaced the phrase "person with overall responsibility for the engagement" with the term "engagement partner." Footnote 3 of AS No. 7 explains that the term "engagement partner" has the same meaning as the phrases the "auditor with final responsibility for the audit," as described in AU sec. 311, *Planning and Supervision*, and the "practitioner-in-charge of an engagement," as described 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*. Because all of these terms refer to the same person, this change does not alter the meaning of the EQR standard.

[19] AS No. 7 does not prohibit the engagement team from consulting with the reviewer, as long as the reviewer maintains his or her objectivity in accordance with paragraph 7. As noted in the reproposing release, such consultations may contribute to audit quality. In addition, one commenter asked the Board to clarify whether a reviewer may consult with the same personnel who previously consulted with the engagement team. The EQR standard does not prohibit the reviewer from holding discussions with such personnel. The reviewer may not, however, use personnel who previously consulted with the engagement team as assistants in performing the review unless they meet the objectivity and other qualification requirements of AS No. 7. To emphasize the requirement that assistants maintain objectivity, the Board added to paragraph 7 of AS No. 7 the phrase "and others who assist the reviewer."

The Two-Year "Cooling-Off" Period

The reproposed standard included a provision prohibiting an engagement partner from serving as the engagement quality reviewer for at least two years following his or her last year as the engagement partner.[20] The Board included the "cooling-off" period because it believed that it would be harder for an engagement partner who has had overall responsibility for the audit for at least a year to perform the review with the necessary level of objectivity. While a number of commenters expressed general support for a two-year "cooling-off" period, some believed that it could impose an undue hardship on smaller firms, and suggested a shorter "cooling-off" period.

After considering these comments, the Board continues to believe that a "cooling-off" period will be beneficial to audit quality and that a two-year period appropriately safeguards objectivity without imposing unnecessary hardship on most firms. At the same time, the Board recognizes that compliance with this requirement could be difficult for smaller firms with fewer personnel. In its independence rules, the Securities and Exchange Commission ("SEC") exempted certain smaller firms from the audit partner rotation requirements. Specifically, Rule 2-01(c)(6)(ii) of Regulation S-X provides an exemption for firms with fewer than five issuer audit clients and fewer than ten partners, provided the Board "conducts a review at least once every three years of each of the audit client engagements that would result in a lack of auditor independence under" the SEC partner rotation requirements. The Board believes that this exemption—including the provision regarding Board inspections—also describes an appropriate exemption from the "cooling-off" requirement in the EQR standard. Accordingly, firms that qualify for the exemption from the SEC partner rotation requirements will also be exempt from the "cooling-off" period under AS No. 7.

D. EQR Process

The Board's goal in proposing an EQR standard was to strengthen the existing requirements for concurring reviews in order to promote a more meaningful review of the work performed by the engagement team. Accordingly, the original proposal described certain procedures that the reviewer was required to perform that were more specific than those in the existing requirements. In response to comments received on the original proposal, the Board clarified some of the specifically required procedures and included, in a separate section in the reproposed standard, tailored requirements for an EQR of an interim review.

In general, commenters believed that the reproposed standard described the requirements of the EQR more clearly than the original proposal. However, a number of commenters suggested additional modifications that, in their view, would further clarify the Board's intent and ensure consistency of the requirements with the statement of objective. As described below, after considering these comments, the Board has modified certain of these requirements.

Terminology Used to Describe the Required Procedures

Several commenters noted that the specifically required procedures in paragraphs 9, 10, 14, and 15 of the reproposed standard were described using different, but in some cases similar, terms such as "determine," "evaluate," "identify,"

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[20] SEC independence rules allow engagement partners and concurring partners to serve for five consecutive years, after which they may not serve in either role for another period of five years. Within a five-year period, SEC independence rules do not impose a "cooling-off" period before the engagement partner can serve as the concurring partner. See Rule 2-01(c)(6)(i)(A) of Regulation S-X.

"read," and "review," which some commenters found confusing. In one commenter's view, the terms "determine," "identify," and "evaluate" may require the reviewer to perform procedures that are similar in scope to the procedures performed by the engagement partner. The commenters asked the Board to clarify the terminology in these sections of the EQR standard.

While the Board does not believe that this terminology required the reviewer to perform procedures that are appropriately performed by the engagement partner, it does agree that the terminology should not be confusing. Accordingly, the Board reduced the number of terms used in AS No. 7, so that the required procedures in paragraphs 9, 10, 14, and 15 are described using two terms, "evaluate" and "review"—with one exception. Because AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, requires the auditor to *read* other information in documents containing the financial statements to be filed with the SEC, paragraphs 10.g and 15.e of AS No. 7, like in the original and reproposed standards, also require the reviewer to *read* such other information and evaluate whether the engagement team has taken appropriate action with respect to any material inconsistencies with the financial statements or interim financial information, respectively, or material misstatements of fact of which the engagement quality reviewer is aware.

Review of Documentation

A number of commenters viewed the statement in paragraphs 9 and 14 of the reproposed standard that "the reviewer should perform the procedures . . . by reviewing documentation" as too open-ended.[21] Commenters were concerned that this provision could be interpreted to require the review of all of the engagement documentation.

The Board did not intend to require—and the reproposed provision did not require—the reviewer to review all of the engagement documentation. Nevertheless, to clarify this point, the Board has added the phrase "to the extent necessary to satisfy the requirements" of paragraphs 10 and 11, in an EQR of an audit, and 15 and 16, in an EQR of an interim review. As a practical matter, the reviewer cannot comply with the requirements of the EQR standard without holding discussions with the engagement partner and reviewing documentation. AS No. 7 requires the reviewer to hold sufficient discussions with the engagement partner and other members of the engagement team and review sufficient documentation to perform the required procedures with due professional care. What is sufficient will necessarily depend on the facts and circumstances of the particular engagement under review. Auditors often document their significant judgments and conclusions in various summary documents, which could serve as a starting point for the reviewer's evaluation of the engagement team's work.

Paragraph 11 of the reproposed standard required the reviewer, in an EQR of an audit, to evaluate whether the engagement documentation that he or she reviewed when performing the procedures required by paragraph 10 indicates that the engagement team responded appropriately to significant risks and supports the conclusions reached by the engagement team with respect to the matters reviewed. One commenter suggested adding a requirement to paragraph 11 to evaluate engagement documentation for compliance with the requirements of Auditing Standard No. 3, *Audit Documentation* ("AS No. 3").

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[21] That statement was intended, along with other changes in the reproposed standard, to clarify that the EQR is a review of the engagement team's work rather than a second audit. See page 17 of the reproposing release.

The Board originally proposed such a requirement but, in response to comments, did not include it in the reproposed standard.[22] The Board continues to believe that the documentation review requirements of paragraph 11 of the reproposed standard are appropriate and is adopting them as reproposed.

In an EQR of an interim review, paragraph 16 of the reproposed standard required the reviewer to evaluate whether the engagement documentation that he or she reviewed "[i]ndicates that the engagement team responded appropriately to significant risks," and "[s]upports the conclusions reached by the engagement team with respect to the matters reviewed." Some commenters noted that the auditor is not required to identify significant risks in a review of interim financial information and suggested not including a corresponding requirement in the EQR standard. The Board agrees and has not included this requirement in AS No. 7.

Specifically Required Procedures in the EQR of an Audit

Like the original proposal, the reproposed standard required certain procedures designed to give the reviewer the necessary information to evaluate the engagement team's significant judgments and conclusions. In response to comments on the original proposal, the Board made changes to these provisions in the reproposed standard that were intended to clarify that the reviewer performs the EQR by reviewing the engagement team's work, rather than by auditing the company himself or herself. Some commenters suggested that the specifically required procedures in the reproposed standard needed additional clarification.

In the view of several commenters, the reproposed standard did not clearly articulate the requirement for the reviewer to focus on the significant judgments made and the related conclusions reached by the engagement team. These commenters believed that the reproposed standard might be interpreted as requiring the review of all of the engagement team's judgments and conclusions. In response, AS No. 7 refers to "significant judgments" instead of "judgments" in describing certain of the required procedures.

The Board also clarified the wording of paragraph 10.b of the reproposed standard, which required the reviewer to "evaluate the risk assessments and audit responses. . . ." Some commenters expressed concern that this formulation required a review of audit responses for all areas of the audit. In response, AS No. 7 more specifically requires the reviewer to evaluate the engagement team's audit responses to significant risks identified by the engagement team and other significant risks identified by the engagement quality reviewer through performance of the procedures required by the EQR standard.[23] This change should help focus reviewers on areas of the audit that are more likely to contain a significant engagement deficiency.

Some commenters also expressed concern about the requirements in paragraphs 10.e and 10.f of the reproposed standard to determine whether appropriate matters have been communicated to the audit committee, management, and others; and to determine whether appropriate consultations have taken

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[22] Commenters suggested that such a requirement would duplicate the documentation review performed by the engagement partner.

[23] The term "significant risk" is defined in the Board's recently proposed auditing standard on identifying and assessing risks of material misstatement to mean a "risk of material misstatement that is important enough to require special audit consideration." PCAOB Release No. 2008-006, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards* (October 21, 2008). The Board intends that definition to apply to the EQR standard as well. The Board included this definition in a note to paragraph 10.b of AS No. 7. If, at the conclusion of the above mentioned rulemaking, the Board adopts a definition of significant risk that is different from that proposed, the Board will make a conforming change to the EQR standard.

place on difficult or contentious matters. According to these commenters, a requirement to determine whether all of the communications or consultations have taken place rather than to evaluate the engagement team's communications and consultations was inconsistent with the objective of the EQR. In response, the Board replaced the phrase "determine if" with "based on the procedures required by this standard, evaluate whether." This change should tailor the specific requirements more closely to the overall objective. The Board also placed these paragraphs after the other required procedures in paragraph 10 to emphasize that the reviewer performs the evaluation required by these paragraphs based on the information obtained through the other procedures required by the EQR standard, and made a corresponding change in paragraph 15 for the EQR of an interim review.

Specifically Required Procedures in the EQR of an Interim Review

In response to comments on the original proposal, the Board included in the reproposed standard separate requirements for reviewing audits and interim reviews. The EQR requirements for interim reviews were based on the requirements for an EQR of an audit but were tailored to the different procedures performed in an interim review. A number of commenters were supportive of including separate requirements for the EQR of interim reviews in the reproposed standard. Some commenters, as discussed below, suggested modifications to those requirements.

Paragraph 15.a of the reproposed standard required the evaluation of engagement planning, including the consideration of the firm's recent engagement experience with the company and risks identified in connection with the firm's client acceptance and retention process; the company's business, recent significant activities, and related financial reporting issues and risks; and the nature of identified risks of material misstatement due to fraud. In one commenter's view, that paragraph might suggest that an interim review should include the same type of risk assessment as an audit. After considering this comment, the Board disagrees. Paragraph 15.a does not impose a requirement on the engagement team to identify risks as part of an interim review. Rather, it requires the reviewer to evaluate the engagement team's consideration of risks that have already been identified, e.g., during the preceding year's audit.

Additionally, three commenters recommended not requiring the EQR of an interim review to include an evaluation of judgments made about the severity and disposition of identified control deficiencies. In one commenter's view, such an evaluation would be inconsistent with the scope of an interim review. AU sec. 722.07, provides that the auditor:

> should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302 of the Act.

In response, the Board modified the requirement in paragraph 15.b in AS No. 7 to be more consistent with the requirements of AU sec. 722. Accordingly, AS No. 7 requires the reviewer, among other things, to evaluate significant judgments made about any material modifications that should be made to the disclosures about changes in internal control over financial reporting.

Paragraph 15.c of the reproposed standard required the reviewer, in the EQR of an interim review, to "[r]ead the interim financial information for all periods presented and for the immediately preceding interim period, management's disclosure for the period under review, if any, about changes in internal control

over financial reporting, and the related engagement report, if a report is to be filed with the SEC." Some commenters suggested that the reviewer should be required to read the engagement report even when the issuer is not required to include the report in an SEC filing. The Board agrees and, accordingly, changed "to be filed with the SEC" to "to be issued."[24]

E. Concurring Approval of Issuance

For an EQR of an audit, paragraph 12 of the reproposed standard provided that the reviewer "may provide concurring approval of issuance only if, after performing with due professional care the review required by this standard, he or she is not aware of a significant engagement deficiency." A note to the same paragraph describes a "significant engagement deficiency" as any of the four conditions described in the original proposal.[25] The reproposed requirements for providing concurring approval of issuance in an EQR of an interim review were the same, except that the first of these four conditions was modified in light of the differences between an interim review and an audit. Specifically, in an EQR of an interim review, the first condition was "the engagement team failed to perform interim review procedures necessary in the circumstances of the engagement" rather than "the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB."

Commenters generally believed that the concurring approval of issuance provision was appropriately described, though one recommended excluding the reference to "due professional care" from the EQR standard because AU sec. 230, *Due Professional Care in the Performance of Work*, already imposes an overall requirement on auditors to exercise due professional care. Many commenters, however, were critical of the reproposing release's description of the reproposed requirement. A significant number of commenters objected to, or stated that they disagreed with, the statement in the reproposing release that the requirement to exercise due professional care imposes on the engagement quality reviewer essentially the same requirement as the "knows, or should know based on the requirements of this standard" formulation that was originally proposed. Some suggested that the Board is redefining the meaning of due professional care. One commenter stated that "[a] standard of 'knows, or should know' is akin to a strict liability requirement for engagement deficiencies," while another commenter suggested that the Board "clarify that in this context, 'due professional care' is not a negligence standard."

After considering the comments, the Board is adopting the concurring approval of issuance requirement as reproposed. While auditors are already required to exercise due professional care in discharging their responsibilities, comments, as noted above and in the reproposing release, have reflected some confusion about the applicable standard of care in an EQR. Accordingly, reference to due professional care in the requirement is appropriate.

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[24] Additionally, one commenter recommended not requiring the reviewer to read interim financial information "for the immediately preceding interim period" because it was not clear, to this commenter, what one would review when performing the EQR for the first quarter. AU sec. 722.16 requires the accountant to apply analytical procedures to the interim financial information, which should include, among other things, comparing the quarterly interim financial information with comparable information for the immediately preceding interim period (i.e., the fourth quarter of the prior year, in a first quarter interim review). Because the Board believes the reproposed requirement is appropriately within the scope of an EQR for an interim review, it has retained it in AS No. 7.

[25] As included in the reproposed standard, these conditions were: (1) the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB; (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement; (3) the engagement report is not appropriate in the circumstances; or (4) the firm is not independent of its client.

The Board is not redefining due professional care in the context of the EQR standard. As the Board noted in the reproposing release, AU sec. 230 describes due professional care as "reasonable care and diligence" and makes clear that an auditor who acts negligently, i.e., without "reasonable care and diligence," breaches the duty to exercise due professional care.[26] Due professional care, as described in AU sec. 230, imposes neither a strict liability nor an actual knowledge standard. The Board intends the term to mean "reasonable care and diligence," as described in AU sec. 230.

The application of a negligence standard to the concurring approval of issuance provision means, as noted in the reproposing release, that "a reviewer cannot evade responsibility because, as a result of an inadequate review, he or she did not discover a problem that a reasonably careful and diligent review would have revealed."[27] For that reason, the provision requires the reviewer to perform the required review with due professional care as a prerequisite to providing concurring approval of issuance. A qualified reviewer who has done so will, necessarily, have discovered any significant engagement deficiencies that could reasonably have been discovered under the circumstances. Accordingly, under AS No. 7, such a reviewer may provide concurring approval of issuance if "he or she is not aware of a significant engagement deficiency." Because a reviewer who has not performed the required review with due professional care might not have discovered any significant engagement deficiencies that could reasonably have been discovered under the circumstance—si.e., those the reviewer reasonably should know about—such a reviewer may not, consistent with the standard, provide concurring approval of issuance.

F. Documentation of the EQR

The reproposed standard required the EQR documentation to contain sufficient information to identify: who performed the review, the documents reviewed, whether and when concurring approval of issuance was provided or the reasons for not providing the approval, and the significant discussions held, including the details of such discussions. These provisions were intended to respond to comments expressing concern that the originally proposed documentation requirements were overly detailed and would result in duplication of the engagement team's work. Some commenters reiterated their concerns that some of the reproposed requirements were duplicative of requirements to document the engagement itself or overly burdensome.

The Board continues to believe that it is necessary to strengthen the documentation requirements in the interim standard to provide for an informative record of the work performed during the EQR. At the same time, the Board has reconsidered its approach to the documentation requirement in light of the comments received. As described below, the Board has added a general requirement that places the specific requirements in the context of the overall purpose of EQR documentation—to provide a record of how the reviewer carried out the review in accordance with the standard's requirements.

Specifically, paragraph 19 of AS No. 7 includes a requirement for the engagement documentation to contain sufficient information to enable an experienced

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[26] See AU sec. 230.03.

[27] Of course, to impose the more severe sanctions authorized under the Act, such as a permanent bar or permanent revocation of registration, the Board must establish "(A) intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard; or (B) repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard." Section 105(c)(5) of the Act; see also Rules on Investigations and Adjudications, PCAOB Release No. 2003-015, Appendix 2 at A2-76 (September 29, 2003) (discussing Section 105(c)(5)).

auditor,[28] having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of the standard.[29] This provision is similar to the audit documentation requirement in paragraph 6 of AS No. 3, and should clarify how the more specific requirements are meant to apply in particular circumstances.

For example, if a reviewer identified a significant engagement deficiency to be addressed by the engagement team, the engagement team should document its response to the identified deficiency in accordance with AS No. 3. Because AS No. 7 does not require duplication of documentation prepared by the engagement team, the engagement quality reviewer does not have to separately document the engagement teams response. Rather, the EQR documentation should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand, e.g., the significant deficiency identified, how the reviewer communicated the deficiency to the engagement team, why such matter was important, and how the reviewer evaluated the engagement team's response. Similarly, if the reviewer participated in the discussion of the potential for material misstatement due to fraud,[30] and the engagement team documented the discussion in accordance with AS No. 3, AS No. 7 only requires the engagement quality reviewer or reviewer's assistants to prepare separate documentation if the documentation prepared by the engagement team does not contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of AS No. 7.

In response to comments, the Board also considered whether modifications were necessary to the specific requirements. First, the Board received several comments related to the provisions of reproposed paragraph 19.b, which required the EQR documentation to contain information sufficient to identify the documents reviewed. One commenter believed that a reviewer "may feel compelled to engage in an unnecessary review of additional documents in order to compile a more 'complete' list." Conversely, another commenter believed that the reviewer would be discouraged "to inspect one or more documents than he or she otherwise might or should, thus reducing the quality of the EQR." Some commenters suggested clarifying how the documents should be identified as "reviewed" (i.e., electronically or manually), or suggested limiting the scope of paragraph 19.b to "significant documents."

After considering these comments, the Board has decided to include this requirement in AS No. 7. Identifying a document as reviewed by the engagement quality reviewer should not be unduly burdensome, and will provide an informative record. Such a record could provide registered firms, and the Board, with better information about the EQR, which can be used to evaluate and improve the EQR process. The Board believes it is unnecessary to require in the standard a particular document identification method, such as electronic or manual signature. Rather, this should be determined by each firm individually.

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[28] As described in paragraph 6 of AS No. 3, "[a]n experienced auditor has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry."

[29] Additionally, for clarity of presentation, the Board moved the requirement to include documentation of an EQR in the engagement documentation from paragraph 19 to a new paragraph 20 in AS No. 7.

[30] See paragraph .14 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

Second, a number of commenters believed that the requirement in paragraph 19.c to document details of significant discussions held by the reviewer, and others who assisted the reviewer, would not improve audit quality and that it would be costly to implement. These commenters suggested that the reviewer might not be able to determine whether a discussion is significant at the time a discussion is held and therefore feel compelled to document every discussion. In order to make clear that documentation of every discussion is neither required nor a prudent use of resources, the Board has not included an explicit requirement to document discussions in AS No. 7. As explained above, however, if documentation of a particular discussion is necessary "to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed . . . to comply with the provisions of th[e] standard," such documentation is required under the general documentation requirement.

G. Effective Date

In reproposing the standard, the Board intended to make a final standard effective for EQRs of interim reviews for fiscal years beginning after December 15, 2009 and for EQRs of audits for fiscal years ending on or after December 15, 2009. Several commenters were concerned that the proposed effective date would not allow for sufficient time to train the auditing firm's personnel and implement the new EQR requirements. These commenters recommended that the effective date of the EQR standard be linked to the beginning of an audit period to provide adequate time for registered firms to prepare for adoption. The Board agrees with the concerns expressed by the commenters and has decided to make AS No. 7 effective, subject to SEC approval, for both the EQR of audits and the EQR of interim reviews for fiscal years beginning on or after December 15, 2009.

H. Comparison with other EQR Standards

Three commenters suggested that the Board provide a comparison between the EQR standard and standards of other standard-setters on this subject. One commenter noted that because issuer clients often represent a minor part of a smaller firm's audit client base, the audit methodology of such a firm may be based on other standards as well as PCAOB standards. In response, the Board has described certain significant differences between the Board's EQR standard and the analogous standards of the International Auditing and Assurance Standards Board ("IAASB")[31] and the Auditing Standards Board ("ASB") of the AICPA[32] in Appendix 3. Each section of the appendix also includes references to the relevant paragraphs of AS No. 7.

Appendix 3 is provided for informational purposes only. It describes only certain provisions of AS No. 7, and is not a substitute for the EQR standard itself. The full text of AS No. 7 is included in Appendix 1 of this release. Compliance with AS No. 7 is required for registered public accounting firms. Compliance with the analogous ASB and IAASB standards is not sufficient to meet the requirements of AS No. 7.

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[31] International Standard on Quality Control 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, and International Standard on Auditing 220, *Quality Control for an Audit of Financial Statements*, issued in December 2008.

[32] AICPA, Statement on Quality Control Standards No. 7, *A Firm's System of Quality Control* (October 2007).

On the 28th day of July, in the year 2009, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Secretary
July 28, 2009

APPENDICES—

1. Auditing Standard No. 7—*Engagement Quality Review*
2. Conforming Amendment to PCAOB Interim Quality Control Standards
3. *Analysis of Significant Differences between the Requirements of Auditing Standard No. 7*, Engagement Quality Review, *of the PCAOB and the Analogous Standards of the IAASB, and the Auditing Standards Board of the AICPA*

Appendix 1

Auditing Standard No. 7—*Engagement Quality Review*

[Appendix omitted; see Auditing Standard No. 7 for the full text of the standard.]

Appendix 2

Conforming Amendment to PCAOB Interim Quality Control Standards

[Appendix omitted; see appendix 2 in PCAOB Release No. 2009-004 for a list of the amendments.]

Appendix 3

Analysis of Significant Differences between the Requirements of Auditing Standard No. 7, Engagement Quality Review, *of the PCAOB and the Analogous Standards of the IAASB, and the Auditing Standards Board of the AICPA*

[Appendix omitted; see appendix 3 in PCAOB Release No. 2009-004 for a full analysis.]

Auditing Standard No. 8

Audit Risk

[Effective pursuant to SEC Release No. 34-63606, File No. PCAOB 2010-01 (December 23, 2010).]

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]

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[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. 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 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]

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[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*.

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

Attachment

PCAOB Release No. 2010-004

PCAOB Release No. 2010-004
August 5, 2010
PCAOB Rulemaking
Docket Matter No. 026

Summary

After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") is adopting eight auditing standards related to the auditor's assessment of and response to risk that will supersede six of the Board's interim auditing standards and related amendments to PCAOB standards. The eight auditing standards and related amendments will be applicable to all registered firms conducting audits in accordance with PCAOB standards.

Board Contacts

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I. Introduction

The Board is adopting 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.[1] 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.[2]

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

[1] 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*.

[2] AU sec. 319.

could improve risk assessment;[3] advice from the Board's Standing Advisory Group ("SAG");[4] 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").[5] 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.*[6] 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 integrated audit when the auditor is performing an integrated audit.

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

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[3] 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.

[4] Webcasts of SAG meetings are available on the Board's Web site at: http://www.pcaobus.org/News_and_Events/Webcasts.

[5] PCAOB Release No. 2008-006, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (October 21, 2008).

[6] Paragraphs .14–.51 and paragraphs .68–.78 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

a foundation for future standards-setting, the Board reproposed the standards for public comment on December 17, 2009 ("the reproposed standards").[7]

The Board received 23 comment letters on the reproposed standards.[8] The Board discussed the comments received with the SAG on April 8, 2010.[9] 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*

Appendices 1–8 of this release present the auditing standards, and Appendix 9 presents the related amendments to PCAOB standards.

II. 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. Appendix 10 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.

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[7] PCAOB Release No. 2009-007, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (December 17, 2009).

[8] 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.

[9] 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.

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 performed by other auditors.[10] Appendix 10 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.[11] 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.[12]

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.[13] 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

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[10] 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*.

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

[12] Paragraphs 61 and B13 of Auditing Standard No. 5.

[13] Paragraph 34 of Auditing Standard No. 5.

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.[14] 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.[15]

III. Additional Discussion of Standards and Comments

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.

Appendix 10 of this release has been expanded to provide additional background for certain requirements in the Board's standards and further discussion of the Board's responses to comments, including the basis for its conclusions regarding certain requirements.

In analyzing comments on the appendix to the reproposed standards that compared the reproposed standards to the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants, 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, e.g., in the appendix that provided additional discussion of comments.

Appendix 10 of this release discusses the principal rationale for the objectives and requirements in the standards being adopted today. Appendix 11 of this release discusses certain differences between the objectives and requirements

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[14] Paragraphs 37–38 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

[15] Paragraph 13 of Auditing Standard No. 12 and paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*.

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, Appendix 11 contains a reference to the discussion of the Board's requirements in Appendix 10.

IV. Effective Date

The release accompanying the reproposed standards stated that the Board expects that the standards would be effective for audits of fiscal years beginning on or after December 15, 2010, subject to approval by the Securities and Exchange Commission ("SEC"), 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 SEC 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.

* * *

On the 5th day of August, in the year 2010, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Secretary

APPENDICES—

1. Auditing Standard No. 8—*Audit Risk*
2. Auditing Standard No. 9—*Audit Planning*
3. Auditing Standard No. 10—*Supervision of the Audit Engagement*
4. Auditing Standard No. 11—*Consideration of Materiality in Planning and Performing an Audit*
5. Auditing Standard No. 12—*Identifying and Assessing Risks of Material Misstatement*
6. Auditing Standard No. 13—*The Auditor's Responses to the Risks of Material Misstatement*
7. Auditing Standard No. 14—*Evaluating Audit Results*
8. Auditing Standard No. 15—*Audit Evidence*
9. Amendments to PCAOB Standards
10. Additional Discussion of Auditing Standards, Amendments to PCAOB Standards, and Comments on Reproposed Standards
11. Comparison of the Objectives and Requirements of the Accompanying PCAOB Auditing Standards with the Analogous Standards of the IAASB and the Auditing Standards Board of the AICPA

Appendix 1

Auditing Standard No. 8, *Audit Risk*

[Appendix omitted; see Auditing Standard No. 8 for the full text of the standard.]

Appendix 2

Auditing Standard No. 9, *Audit Planning*

[Appendix omitted; see Auditing Standard No. 9 for the full text of the standard.]

Appendix 3

Auditing Standard No. 10, *Supervision of the Audit Engagement*

[Appendix omitted; see Auditing Standard No. 10 for the full text of the standard.]

Appendix 4

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

[Appendix omitted; see Auditing Standard No. 11 for the full text of the standard.]

Appendix 5

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

[Appendix omitted; see Auditing Standard No. 12 for the full text of the standard.]

Appendix 6

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

[Appendix omitted; see Auditing Standard No. 13 for the full text of the standard.]

Appendix 7

Auditing Standard No. 14, *Evaluating Audit Results*

[Appendix omitted; see Auditing Standard No. 14 for the full text of the standard.]

Appendix 8

Auditing Standard No. 15, *Audit Evidence*

[Appendix omitted; see Auditing Standard No. 15 for the full text of the standard.]

Appendix 9

Amendments to PCAOB Standards

[Appendix omitted; see appendix 9 in PCAOB Release No. 2010-004 for a list of the amendments.]

Appendix 10

Additional Discussion of Auditing Standards, Amendments to PCAOB Standards, and Comments on Reproposed Standards

[Appendix omitted; see appendix 10 in PCAOB Release No. 2010-004 for a full discussion.]

Appendix 11

Comparison of the Objectives and Requirements of the Accompanying PCAOB Auditing Standards with the Analogous Standards of the IAASB and the Auditing Standards Board of the AICPA

[Appendix omitted; see appendix 11 in PCAOB Release No. 2010-004 for a full comparison.]

Auditing Standard No. 9

Audit Planning

Source: Auditing Standard No. 16.

[Effective pursuant to SEC Release No. 34-63606, File No. PCAOB 2010-01 (December 23, 2010).]

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** [1] 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.[2]

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 following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

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,[3]

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

[2] 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.

[3] 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.

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 of the terms of the audit engagement with the audit committee in accordance with Auditing Standard No. 16, *Communications with Audit Committees*.[4]

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,[5] risk, and, in integrated audits, other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee[6] 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

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[4] *[Footnote deleted, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

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

[6] 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).

- 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,[7]

b. The factors that are significant in directing the activities of the engagement team,[8]

c. The results of preliminary engagement activities[9] 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.[10]

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;[11]

b. The planned nature, timing, and extent of tests of controls and substantive procedures;[12] and

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

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[7] See, e.g., Auditing Standard No. 16, *Communications 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. *[Footnote revised, effective for fiscal years ending on or after December 15, 2012, by PCAOB Release No. 2012-004.]*

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

[9] Paragraph 6 of this standard.

[10] 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*.

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

[12] 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*.

Multi-location Engagements

11. In an audit of the financial statements of a company with operations in multiple locations or business units,[13] 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;[14]

b. The materiality of the location or business unit;[15]

c. The specific risks associated with the location or business unit that present a reasonable possibility[16] 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[17] for considerations when a company has multiple locations or business units.

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

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

[15] 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.

[16] 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.

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

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.[18] 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:

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*.

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

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.[19]

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

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.

Attachment

PCAOB Release No. 2010-004

PCAOB Release No. 2010-004
August 5, 2010

PCAOB Rulemaking
Docket Matter No. 026

Summary

After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") is adopting eight auditing standards related to the auditor's assessment of and response to risk that will supersede six of the Board's interim auditing standards and related amendments to PCAOB standards. The eight auditing standards and related amendments will be applicable to all registered firms conducting audits in accordance with PCAOB standards.

To view the release in its entirety, see the "Attachment" section of Auditing Standard No. 8.

Auditing Standard No. 10

Supervision of the Audit Engagement

[Effective pursuant to SEC Release No. 34-63606, File No. PCAOB 2010-01 (December 23, 2010).]

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**[1] 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,[2] other auditors,[3] internal auditors,[4] and others who are involved in testing controls.[5] Paragraphs 5–6 of this standard describe the nature and extent of supervisory activities necessary for proper supervision of engagement team members.[6]

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:

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

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

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

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

[5] 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.*

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

a. Inform engagement team members of their responsibilities,[7] 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,[8] 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;[9]

   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.[10]

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;[11]

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

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[7] 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.

[8] 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.

[9] 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.*

[10] 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.

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

d. The knowledge, skill, and ability of each engagement team member.[12]

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.[13]

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

[13] 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.

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.

Attachment

PCAOB Release No. 2010-004

PCAOB Release No. 2010-004
August 5, 2010

PCAOB Rulemaking
Docket Matter No. 026

Summary

After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") is adopting eight auditing standards related to the auditor's assessment of and response to risk that will supersede six of the Board's interim auditing standards and related amendments to PCAOB standards. The eight auditing standards and related amendments will be applicable to all registered firms conducting audits in accordance with PCAOB standards.

To view the release in its entirety, see the "Attachment" section of Auditing Standard No. 8.

Auditing Standard No. 11

Consideration of Materiality in Planning and Performing an Audit

[Effective pursuant to SEC Release No. 34-63606, File No. PCAOB 2010-01 (December 23, 2010).]

Introduction

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

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."[2] 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. . . ."[3]

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.[4] 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."[5]

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

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

[3] TSC Industries, 426 U.S. at 450.

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

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

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 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.[6]

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

Attachment

PCAOB Release No. 2010-004

PCAOB Release No. 2010-004
August 5, 2010

PCAOB Rulemaking
Docket Matter No. 026

Summary

After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") is adopting eight auditing standards related to the auditor's assessment of and response to risk that will supersede six of the Board's interim auditing standards and related amendments to PCAOB standards. The eight auditing standards and related amendments will be applicable to all registered firms conducting audits in accordance with PCAOB standards.

To view the release in its entirety, see the "Attachment" section of Auditing Standard No. 8.

Auditing Standard No. 12

Identifying and Assessing Risks of Material Misstatement

[Effective pursuant to SEC Release No. 34-63606, File No. PCAOB 2010-01 (December 23, 2010).]

Introduction

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

2. Paragraphs 4–58 of this standard discuss the auditor's responsibilities for performing **risk assessment procedures**.[2] 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.

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,[3] and designing further audit procedures.[4]

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

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

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

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

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

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).

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.[5]

6. In an integrated audit, the risks of material misstatement of the financial statements are the same for both the audit of internal control over financial reporting and the audit of 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.

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

Industry, Regulatory, and Other External Factors

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

Nature of the Company

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

- The 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;

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

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

- 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 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[8] of internal control over financial reporting ("understanding of internal control") to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.

19. The nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control depend on the size and complexity of the company;[9] the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's controls, including the 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.[10]

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.

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

[9] 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."

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

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:[11]

- 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.[12] 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."[13] If the auditor uses a suitable, recognized internal control framework with components that differ from those listed in the preceding paragraph, the auditor should adapt the requirements in paragraphs 23–36 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

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

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

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

- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

  Note: In an audit of financial statements only, this assessment may be based on the evidence obtained in understanding the control environment, in accordance with paragraph 23, and the other relevant knowledge possessed by the auditor. In an integrated audit of financial statements and internal control over financial reporting, Auditing Standard No. 5[14] describes the auditor's responsibility for evaluating the control environment.

25. If the auditor identifies a control deficiency[15] 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,[16] that are significant to the financial statements; and

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

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

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

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;[17]
- 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.[18] As the auditor obtains an understanding of the other components

[17] Paragraphs 12–13 of this standard.

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

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.[19]

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 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.[20]

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

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[19] 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.

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

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[21] or for the purpose of expressing an opinion on internal control over financial reporting in the audit of internal control over financial reporting.[22] 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."[23] 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.[24] 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

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

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

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

[24] 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.

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[25] and should take into account relevant information obtained from those engagements in identifying risks of material misstatement.[26]

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 her understanding of the company to develop expectations about plausible relationships among the data to be used in the procedure.[27] 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.

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

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

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

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.[28]

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.[29]

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

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[28] Paragraphs 52–53 of this standard.

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

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;[30]
- 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.[31]

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.

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[30] AU sec. 316.13.

[31] 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.

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 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.[32]

e. Identify significant accounts and disclosures[33] and their relevant assertions[34] (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;

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

[33] 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.

[34] 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.

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

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.[35]

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

[35] 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.

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.[36]

73. Controls that address fraud risks include (a) specific controls designed to mitigate specific risks of fraud, e.g., controls to address risks of intentional misstatement of specific accounts and (b) controls designed to prevent, deter, and detect fraud, e.g., controls to promote a culture of honesty and ethical behavior.[37] 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.[38]

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

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

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

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.

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.[1] 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.[2]

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 nonexistent 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.

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[1] 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.

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

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.

Attachment

PCAOB Release No. 2010-004

PCAOB Release No. 2010-004
August 5, 2010

PCAOB Rulemaking
Docket Matter No. 026

Summary

After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") is adopting eight auditing standards related to the auditor's assessment of and response to risk that will supersede six of the Board's interim auditing standards and related amendments to PCAOB standards. The eight auditing standards and related amendments will be applicable to all registered firms conducting audits in accordance with PCAOB standards.

To view the release in its entirety, see the "Attachment" section of Auditing Standard No. 8.

Auditing Standard No. 13

The Auditor's Responses to the Risks of Material Misstatement

[Effective pursuant to SEC Release No. 34-63606, File No. PCAOB 2010-01 (December 23, 2010).]

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 following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

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.[1]

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*.)

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

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.[2]

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,[3] are indicative of bias that could lead to material misstatement of the financial statements.

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.[4] 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.[5] Examples of the application

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[2] 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.

[3] 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.*

[4] AU secs. 230.07–.09.

[5] AU sec. 316.13.

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;[6]

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[7] assessments for purposes of the audit of financial statements;[8] 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.[9] 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.

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

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

[8] 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.

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

Note: Auditing Standard No. 12 discusses identification of significant risks[10] 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.

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.[11]

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).

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

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

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,[12] 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**.[13] 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.[14]

> 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

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[12] 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.

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

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

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.[15]

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 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.

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

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);[16]
- The complexity of the control and the significance of the judgments that must be made in connection with its operation;
- The planned degree of reliance on the control;
- The nature, timing, and extent of procedures performed in past audits;

[16] 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 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.[17] 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.

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

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,[18] 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.[19]

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.

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.

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

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

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.[20]

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

Appendix A

Definitions

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

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

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

Attachment

PCAOB Release No. 2010-004

PCAOB Release No. 2010-004
August 5, 2010

PCAOB Rulemaking
Docket Matter No. 026

Summary

After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") is adopting eight auditing standards related to the auditor's assessment of and response to risk that will supersede six of the Board's interim auditing standards and related amendments to PCAOB standards. The eight auditing standards and related amendments will be applicable to all registered firms conducting audits in accordance with PCAOB standards.

To view the release in its entirety, see the "Attachment" section of Auditing Standard No. 8.

Auditing Standard No. 14
Evaluating Audit Results

[Effective pursuant to SEC Release No. 34-63606, File No. PCAOB 2010-01 (December 23, 2010).]

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,[1] the auditor's evaluation of audit results should include evaluation of the following:

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

b. **Misstatements** accumulated during the audit, including, in particular, **uncorrected misstatements**;[2]

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.

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[1] 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.

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

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[3] indicate risks of material misstatement that were not identified previously, including, in particular, fraud risks.

Note: If the auditor discovers a previously unidentified risk of material misstatement or concludes that the evidence gathered is not adequate, he or she should modify his or her audit procedures or perform additional procedures as necessary in accordance with paragraph 36 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.[4]

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

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[3] 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.*

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

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.*[5]

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.[6]

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

[5] AU sec. 350.26.

[6] Auditing Standard No. 11.

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.[7] (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."[8] 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 ...."[9]

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[10] that it could lead to a material contingent liability or a material loss of revenue.[11] 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,[12] 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.

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[7] 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.

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

[9] TSC Industries, 426 U.S. at 450.

[10] 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.

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

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

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[13] 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.[14]

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).

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

[14] AU sec. 316.05.

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.[15]

d. Bias in accounting estimates.[16]

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.

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[17] and other observations affect the assessment of the fraud risks made throughout the audit and

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

[16] Paragraph 27 of this standard.

[17] 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).

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.[18]

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

[18] AU secs. 508.41–.44.

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.[19]

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.[20]

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.[21]

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.[22] 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.[23]

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

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

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

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

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

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

37. Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* indicates that the auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls, 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.[24]

[24] Paragraphs 62–70 of Auditing Standard No. 5 discuss evaluating identified control deficiencies, and paragraphs 71–73 of Auditing Standard No. 5 discuss forming an opinion on the effectiveness of internal control over financial reporting.

Appendix A

Definitions

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

A2. Misstatement—A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework.[1] A misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework. Misstatements can arise from error (i.e., unintentional misstatement) or fraud.[2]

A3. Uncorrected misstatements—Misstatements, other than those that are clearly trivial,[3] that management has not corrected.

[1] 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.

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

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

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.[1]
>
> 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."[2] 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. . . ."[3]
>
> 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[4] that it could lead to a material contingent liability or a material loss of revenue.[5] 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.

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[1] 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.

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

[3] TSC Industries, 426 U.S. at 450.

[4] 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.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Appendix C

Matters That Might Affect the Assessment of Fraud Risks

C1. If the following matters are identified during the audit, the auditor should 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.[1]
   (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.

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

(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:[2]

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.

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

Attachment

PCAOB Release No. 2010-004

PCAOB Release No. 2010-004
August 5, 2010

PCAOB Rulemaking
Docket Matter No. 026

Summary

After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") is adopting eight auditing standards related to the auditor's assessment of and response to risk that will supersede six of the Board's interim auditing standards and related amendments to PCAOB standards. The eight auditing standards and related amendments will be applicable to all registered firms conducting audits in accordance with PCAOB standards.

To view the release in its entirety, see the "Attachment" section of Auditing Standard No. 8.

Auditing Standard No. 15
Audit Evidence

[Effective pursuant to SEC Release No. 34-63606, File No. PCAOB 2010-01 (December 23, 2010).]

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.[1]

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.[2]
- *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.

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[1] 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.

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

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:[3]

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[3] 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*.

- 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[4] of containing misstatements that would cause the financial statements to be materially misstated, individually or in combination with other misstatements.[5]

Audit Procedures for Obtaining Audit Evidence

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

a. Risk assessment procedures,[6] and
b. Further audit procedures,[7] which consist of:
   (1) Tests of controls, and
   (2) Substantive procedures, including tests of details and substantive analytical procedures.

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[4] 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.

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

[6] Auditing Standard No. 12.

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

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

Inspection

15. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or physically examining an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorization.

Observation

16. Observation consists of looking at a process or procedure being performed by others, e.g., the auditor's observation of inventory counting by the company's personnel or 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.[8]

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.[9]

> 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.[10]

Recalculation

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

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

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

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

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.[11]

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:

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

- *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.[12]

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.[13]

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.

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

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

Attachment

PCAOB Release No. 2010-004

PCAOB Release No. 2010-004
August 5, 2010

PCAOB Rulemaking
Docket Matter No. 026

Summary

After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") is adopting eight auditing standards related to the auditor's assessment of and response to risk that will supersede six of the Board's interim auditing standards and related amendments to PCAOB standards. The eight auditing standards and related amendments will be applicable to all registered firms conducting audits in accordance with PCAOB standards.

To view the release in its entirety, see the "Attachment" section of Auditing Standard No. 8.

Auditing Standard No. 16
Communications with Audit Committees

[Effective pursuant to SEC Release No. 34-68453, File No. PCAOB 2012-01 (December 17, 2012).]

[Supersedes AU sections 310 and 380.]

Introduction

1. This standard requires the auditor to communicate with the company's **audit committee**[1] regarding certain matters related to the conduct of an audit[2] and to obtain certain information from the audit committee relevant to the audit. This standard also requires the auditor to establish an understanding of the terms of the audit engagement with the audit committee and to record that understanding in an engagement letter.

2. Other Public Company Accounting Oversight Board ("PCAOB") rules and standards identify additional matters to be communicated to a company's audit committee (see Appendix B). Various laws or regulations also require the auditor to communicate certain matters to the audit committee.[3] The communication requirements of this standard do not modify or replace communications to the audit committee required by such other PCAOB rules and standards, and other laws or regulations. Nothing in this standard precludes the auditor from communicating other matters to the audit committee.

Objectives

3. The objectives of the auditor are to:

a. Communicate to the audit committee the responsibilities of the auditor in relation to the audit and establish an understanding of the terms of the audit engagement with the audit committee;

b. Obtain information from the audit committee relevant to the audit;

c. Communicate to the audit committee an overview of the overall audit strategy and timing of the audit; and

d. Provide the audit committee with timely observations arising from the audit that are significant to the financial reporting process.

Note: "Communicate to," as used in this standard, is meant to encourage effective two-way communication between the auditor and the audit committee throughout the audit to assist in understanding matters relevant to the audit.

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

[2] For purposes of this standard, an audit is either an audit of internal control over financial reporting that is integrated with an audit of financial statements or an audit of financial statements only.

[3] *See e.g.,* Section 10A(k) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §78j-1(k); Rule 2-07 of Regulation S-X, 17 C.F.R. §210.2-07; and Rule 10A-3 under the Exchange Act, 17 C.F.R. §240.10A-3.

Appointment and Retention

Significant Issues Discussed with Management in Connection with the Auditor's Appointment or Retention

4. The auditor should discuss with the audit committee any significant issues that the auditor discussed with management in connection with the appointment or retention of the auditor, including significant discussions regarding the application of accounting principles and auditing standards.

Establish an Understanding of the Terms of the Audit

5. The auditor should establish an understanding of the terms of the audit engagement with the audit committee. This understanding includes communicating to the audit committee the following:

a. The objective of the audit;

b. The responsibilities of the auditor; and

c. The responsibilities of management.

6. The auditor should record the understanding of the terms of the audit engagement in an engagement letter and provide the engagement letter to the audit committee annually. The auditor should have the engagement letter executed by the appropriate party or parties on behalf of the company.[4] If the appropriate party or parties are other than the audit committee, or its chair on behalf of the audit committee, the auditor should determine that the audit committee has acknowledged and agreed to the terms of the engagement.

Note: Appendix C describes matters that the auditor should include in the engagement letter about the terms of the audit engagement.

7. If the auditor cannot establish an understanding of the terms of the audit engagement with the audit committee, the auditor should decline to accept, continue, or perform the engagement.

Obtaining Information and Communicating the Audit Strategy

Obtaining Information Relevant to the Audit

8. The auditor should inquire of the audit committee about whether it is aware of matters relevant to the audit,[5] including, but not limited to, violations or possible violations of laws or regulations.[6]

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[4] Absent evidence to the contrary, the auditor may rely on the company's identification of the appropriate party or parties to execute the engagement letter.

[5] In addition to this inquiry, paragraphs 5.f. and 54-57 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, describe the auditor's inquiries of the audit committee, or equivalent (or its chair) regarding the audit committee's knowledge of the risks of material misstatement, including fraud risks. These inquiries include, among other things, whether the audit committee is aware of tips or complaints regarding the company's financial reporting.

[6] *See* AU sec. 317, *Illegal Acts by Clients*, for a description of the auditor's responsibilities when a possible illegal act is detected. For audits of issuers, *see also* Section 10A(b) of the Exchange Act, 15 U.S.C. §78j-1(b), and Rule 10A-1 under the Exchange Act, 17 C.F.R. §240.10A-1.

Overall Audit Strategy, Timing of the Audit, and Significant Risks

9. The auditor should communicate to the audit committee an overview of the overall audit strategy, including the timing of the audit,[7] and discuss with the audit committee the significant risks identified during the auditor's risk assessment procedures.[8]

Note: This overview is intended to provide information about the audit, but not specific details that would compromise the effectiveness of the audit procedures.

10. As part of communicating the overall audit strategy, the auditor should communicate the following matters to the audit committee, if applicable:

a. The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results related to significant risks;[9]

b. The extent to which the auditor plans to use the work of the company's internal auditors in an audit of financial statements;[10]

c. The extent to which the auditor plans to use the work of internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee when performing an audit of internal control over financial reporting;[11]

d. The names, locations, and planned responsibilities[12] of other independent public accounting firms or other persons, who are not employed by the auditor, that perform audit procedures in the current period audit; and

Note: The term "other independent public accounting firms" in the context of this communication includes firms that perform audit procedures in the current period audit regardless of whether they otherwise have any relationship with the auditor.

e. The basis for the auditor's determination that the auditor can serve as principal auditor, if significant parts of the audit are to be performed by other auditors.[13]

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[7] *See* paragraphs 8-9 of Auditing Standard No. 9, *Audit Planning*, for a description of the auditor's responsibilities for establishing an overall audit strategy.

[8] Auditing Standard No. 12 requires the auditor to determine whether identified and assessed risks are significant risks. A significant risk is defined as a risk of material misstatement that requires special audit consideration.

[9] *See* paragraph 16 of Auditing Standard No. 9 for the requirement for the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

[10] *See* AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, which describes the auditor's responsibilities related to the work of internal auditors.

[11] *See* 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*, which describe the auditor's responsibilities related to using the work of others in an audit of internal control over financial reporting.

[12] *See* paragraphs 8-14 of Auditing Standard No. 9, which discuss the auditor's responsibilities for determining the audit strategy, audit plan, and extent to which audit procedures should be performed at selected locations or business units involving multi-location engagements.

[13] *See* AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, which discusses the professional judgments the auditor makes in deciding whether the auditor may serve as principal auditor.

11. The auditor should communicate to the audit committee significant changes to the planned audit strategy or the significant risks initially identified and the reasons for such changes.[14]

Results of the Audit

Accounting Policies and Practices, Estimates, and Significant Unusual Transactions

12. The auditor should communicate to the audit committee the following matters:

a. Significant accounting policies and practices.[15]

(1) Management's initial selection of, or changes in, significant accounting policies or the application of such policies in the current period; and

(2) The effect on financial statements or disclosures of significant accounting policies in (i) controversial areas or (ii) areas for which there is a lack of authoritative guidance or consensus, or diversity in practice.

b. **Critical accounting policies and practices**. All critical accounting policies and practices to be used, including:[16]

(1) The reasons certain policies and practices are considered critical; and

(2) How current and anticipated future events might affect the determination of whether certain policies and practices are considered critical.

Note: Critical accounting policies and practices, as defined in Appendix A, are a company's accounting policies and practices that are both most important to the portrayal of the company's financial condition and results, and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain. Critical accounting policies and practices are tailored to specific events in the current year, and the accounting policies and practices that are considered critical might change from year to year.

c. **Critical accounting estimates**.

(1) A description of the process management used to develop critical accounting estimates;[17]

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[14] *See* paragraph 15 of Auditing Standard No. 9, which discusses changes in audit strategy and the audit plan during the course of the audit.

[15] *See, e.g.*, Financial Accounting Standards Board Accounting Standards Codification, Topic 235, Notes to Financial Statements, paragraph 235-10-50-1, which requires the entity to disclose a description of all significant accounting policies as an integral part of the financial statements, and paragraph 235-10-50-3, which describes what should be disclosed.

[16] *See also* Section 10A(k) of the Exchange Act, 15 U.S.C. §78j-1(k), and Rule 2-07(a)(1) of Regulation S-X, 17 C.F.R. §210.2-07(a)(1).

[17] *See* AU sec. 342, *Auditing Accounting Estimates*, which discusses the auditor's responsibilities to obtain and evaluate sufficient appropriate audit evidence to support significant accounting estimates in an audit of financial statements.

(2) Management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity;[18] and

(3) Any significant changes management made to the processes used to develop critical accounting estimates or significant assumptions, a description of management's reasons for the changes, and the effects of the changes on the financial statements.[19]

d. Significant unusual transactions.

(1) 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;[20] and

(2) The policies and practices management used to account for significant unusual transactions.

Note: As part of its communications to the audit committee, management might communicate some or all of the matters in paragraph 12. If management communicates any of these matters, the auditor does not need to communicate them at the same level of detail as management, as long as the auditor (1) participated in management's discussion with the audit committee, (2) affirmatively confirmed to the audit committee that management has adequately communicated these matters, and (3) with respect to critical accounting policies and practices, identified for the audit committee those accounting policies and practices that the auditor considers critical. The auditor should communicate any omitted or inadequately described matters to the audit committee.

Auditor's Evaluation of the Quality of the Company's Financial Reporting

13. The auditor should communicate to the audit committee the following matters:

a. Qualitative aspects of significant accounting policies and practices.

(1) The results of the auditor's evaluation of, and conclusions about, the qualitative aspects of the company's significant accounting policies and practices, including situations in which the auditor identified bias in management's judgments about the amounts and disclosures in the financial statements;[21] and

(2) The results of the auditor's evaluation of the differences between (i) estimates best supported by the audit evidence and (ii) estimates included in the financial statements, which are individually reasonable, that indicate a possible bias on the part of the company's management.[22]

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[18] *Id.*

[19] *Id.*

[20] *See* paragraph 71.g. of Auditing Standard No. 12.

[21] *See* paragraphs 24-27 of Auditing Standard No. 14, *Evaluating Audit Results*, which describe the auditor's responsibilities related to evaluating the qualitative aspects of the company's accounting practices.

[22] *See* paragraph 27 of Auditing Standard No. 14.

b. Assessment of critical accounting policies and practices. The auditor's assessment of management's disclosures related to the critical accounting policies and practices, along with any significant modifications to the disclosure of those policies and practices proposed by the auditor that management did not make.

c. Conclusions regarding critical accounting estimates. The basis for the auditor's conclusions regarding the reasonableness of the critical accounting estimates.[23]

d. Significant unusual transactions. The auditor's understanding of the business rationale for significant unusual transactions.[24]

e. Financial statement presentation. The results of the auditor's evaluation of whether the presentation of the financial statements and the related disclosures are in conformity with the applicable financial reporting framework, including the auditor's 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, and the bases of amounts set forth.[25]

f. New accounting pronouncements. Situations in which, as a result of the auditor's procedures, the auditor identified a concern regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting.

g. Alternative accounting treatments. All alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the auditor.[26]

Other Information in Documents Containing Audited Financial Statements

14. When other information is presented in documents containing audited financial statements, the auditor should communicate to the audit committee the auditor's responsibility under PCAOB rules and standards for such information, any related procedures performed, and the results of such procedures.[27]

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[23] *See* AU sec. 342, which discusses the auditor's responsibilities to obtain and evaluate sufficient appropriate audit evidence to support significant accounting estimates in an audit of financial statements.

[24] *See* paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

[25] *See* paragraphs 30-31 of Auditing Standard No. 14, which describe the auditor's responsibilities related to the evaluation of whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. Other PCAOB standards, such as AU sec. 334, *Related Parties*, and AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, describe the auditor's responsibilities related to evaluation of specific disclosures in financial statements.

[26] *See also* Section 10A(k) of the Exchange Act, 15 U.S.C. §78j-1(k), and Rule 2-07(a)(2) of Regulation S-X, 17 C.F.R. §210.2-07(a)(2).

[27] *See, e.g.*, AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*. In addition to AU sec. 550, discussion of the auditor's consideration of other information is included in AU sec. 558, *Required Supplementary Information*, and AU sec. 711, *Filings Under Federal Securities Statutes*.

Difficult or Contentious Matters for which the Auditor Consulted

15. The auditor should communicate to the audit committee matters that are difficult or contentious for which the auditor consulted outside the engagement team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process.

Management Consultation with Other Accountants

16. When the auditor is aware that management consulted with other accountants about significant auditing or accounting matters and the auditor has identified a concern regarding such matters, the auditor should communicate to the audit committee his or her views about such matters that were the subject of such consultation.

Going Concern

17. The auditor should communicate to the audit committee, when applicable, the following matters relating to the auditor's evaluation of the company's ability to continue as a going concern:[28]

a. If the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the conditions and events that the auditor identified that, when considered in the aggregate, indicate that there is substantial doubt;[29]

b. If the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern is alleviated, the basis for the auditor's conclusion, including elements the auditor identified within management's plans that are significant to overcoming the adverse effects of the conditions and events;[30]

c. If the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time remains:[31]

   (1) The effects, if any, on the financial statements and the adequacy of the related disclosure;[32] and

   (2) The effects on the auditor's report.[33]

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[28] *See* AU sec. 341 for the requirements regarding an auditor's responsibility to evaluate whether there is substantial doubt about a company's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. Additionally, AU secs. 341.03a-c provide the auditor with an overview of the requirements for evaluating whether there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.

[29] *See* AU sec. 341.06, which provides examples of such conditions and events and AU sec. 341.07, which discusses the auditor's procedures if the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.

[30] *See* AU sec. 341.08, which discusses the auditor's responsibilities related to the auditor's evaluation of management's plans.

[31] *See* AU sec. 341.12, which describes the effects on the auditor's report. *See also* AU sec. 341.03c, which discusses the auditor's evaluation of factors that indicate there is substantial doubt about the company's ability to continue as a going concern.

[32] *See* AU sec. 341.10, which discusses the possible effects on the financial statements and the adequacy of the related disclosure.

[33] *See* AU secs. 341.12-.16, which discuss the auditor's consideration of the effects on the auditor's report when the auditor concludes that substantial doubt exists about the company's ability to continue as a going concern for a reasonable period of time.

Uncorrected and Corrected Misstatements

18. The auditor should provide the audit committee with the schedule of uncorrected misstatements related to accounts and disclosures[34] that the auditor presented to management.[35] The auditor should discuss with the audit committee, or determine that management has adequately discussed with the audit committee, the basis for the determination that the uncorrected misstatements were immaterial, including the qualitative factors[36] considered. The auditor also should communicate that uncorrected misstatements or matters underlying those uncorrected misstatements could potentially cause future-period financial statements to be materially misstated, even if the auditor has concluded that the uncorrected misstatements are immaterial to the financial statements under audit.

19. The auditor should communicate to the audit committee those corrected misstatements, other than those that are clearly trivial,[37] related to accounts and disclosures that might not have been detected except through the auditing procedures performed, and discuss with the audit committee the implications that such corrected misstatements might have on the company's financial reporting process.

Material Written Communications

20. The auditor should communicate to the audit committee other material written communications between the auditor and management.[38]

Departure from the Auditor's Standard Report

21. The auditor should communicate to the audit committee the following matters related to the auditor's report:

a. When the auditor expects to modify the opinion in the auditor's report, the reasons for the modification, and the wording of the report; and

b. When the auditor expects to include explanatory language or an explanatory paragraph in the auditor's report, the reasons for the explanatory language or paragraph, and the wording of the explanatory language or paragraph.

Disagreements with Management

22. The auditor should communicate to the audit committee any disagreements with management about matters, whether or not satisfactorily resolved, that individually or in the aggregate could be significant to the company's financial statements or the auditor's report. Disagreements with management do not include differences of opinion based on incomplete facts or preliminary

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[34] Footnote 13 to paragraph 20 of Auditing Standard No. 14 indicates that misstatements include omission and presentation of inaccurate or incomplete disclosures.

[35] *See* Section 13(i) of the Exchange Act, 15 U.S.C.§78m(i), which states, in part, that financial statements prepared in accordance with generally accepted accounting principles and filed with the Securities and Exchange Commission "shall reflect all material correcting adjustments that have been identified by a registered public accounting firm. . . ."

[36] Appendix B of Auditing Standard No. 14 discusses the qualitative factors related to the evaluation of the materiality of uncorrected misstatements.

[37] *See* paragraph 10 of Auditing Standard No. 14, which requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial.

[38] *See also* Section 10A(k) of the Exchange Act, 15 U.S.C. §78j-1(k) and Rule 2-07(a)(3) of Regulation S-X, 17 C.F.R. §210.2-07 (a)(3).

information that are later resolved by the auditor obtaining additional relevant facts or information prior to the issuance of the auditor's report.

Difficulties Encountered in Performing the Audit

23. The auditor should communicate to the audit committee any significant difficulties encountered during the audit. Significant difficulties encountered during the audit include, but are not limited to:

a. Significant delays by management, the unavailability of company personnel, or an unwillingness by management to provide information needed for the auditor to perform his or her audit procedures;

b. An unreasonably brief time within which to complete the audit;

c. Unexpected extensive effort required by the auditor to obtain sufficient appropriate audit evidence;

d. Unreasonable management restrictions encountered by the auditor on the conduct of the audit; and

e. Management's unwillingness to make or extend its assessment of the company's ability to continue as a going concern when requested by the auditor.

Note: Difficulties encountered by the auditor during the audit could represent a scope limitation,[39] which may result in the auditor modifying the auditor's opinion or withdrawing from the engagement.

Other Matters

24. The auditor should communicate to the audit committee other matters arising from the audit that are significant to the oversight of the company's financial reporting process. This communication includes, among other matters, complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit and the results of the auditor's procedures regarding such matters.[40]

Form and Documentation of Communications

25. The auditor should communicate to the audit committee the matters in this standard, either orally or in writing,[41] unless otherwise specified in this standard. The auditor must document the communications in the work papers, whether such communications took place orally or in writing.[42]

Note: If, as part of its communications to the audit committee, management communicated some or all of the matters identified in paragraphs 12 or 18 and, as a result, the auditor did not communicate these matters at the same level of detail as management, the auditor must include a copy of or a summary of

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[39] *See* paragraphs .22-.32 of AU sec. 508, *Reports on Audited Financial Statements*, for a discussion of scope limitations.

[40] AU secs. 316.79-.81 and AU sec. 317.17 include specific communication requirements relating to fraud or illegal acts, respectively.

[41] *See* paragraphs .07-.11 of AU sec. 532, *Restricting the Use of an Auditor's Report*, which apply to certain written reports on matters coming to the auditor's attention during the course of the audit.

[42] Consistent with the requirements of Auditing Standard No. 3, *Audit Documentation*, the audit documentation should be in sufficient detail to enable an experienced auditor, having no previous connection with the engagement, to understand the communications made to comply with the provisions of this standard.

management's communications provided to the audit committee in the audit documentation.

Timing

26. All audit committee communications required by this standard should be made in a timely manner and prior to the issuance of the auditor's report.[43] The appropriate timing of a particular communication to the audit committee depends on factors such as the significance of the matters to be communicated and corrective or follow-up action needed, unless other timing requirements are specified by PCAOB rules or standards or the securities laws.

Note: An auditor may communicate to only the audit committee chair if done in order to communicate matters in a timely manner during the audit. The auditor, however, should communicate such matters to the audit committee prior to the issuance of the auditor's report.

[43] Consistent with Rule 2-07 of Regulation S-X, 17 C.F.R. § 210.2- 07, in the case of a registered investment company, audit committee communication should occur annually, and if the annual communication is not within 90 days prior to the filing of the auditor's report, the auditor should provide an update in the 90-day period prior to the filing of the auditor's report, of any changes to the previously reported information.

Appendix A

Definitions

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

A2. Audit committee—A committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to the company, the entire board of directors of the company.

For audits of nonissuers, if no such committee or board of directors (or equivalent body) exists with respect to the company, the person(s) who oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.

A3. Critical accounting estimate—An accounting estimate where (a) the nature of the estimate is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change and (b) the impact of the estimate on financial condition or operating performance is material.

A4. Critical accounting policies and practices—A company's accounting policies and practices that are both most important to the portrayal of the company's financial condition and results, and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.

Appendix B

Communications with Audit Committees Required by Other PCAOB Rules and Standards

This appendix identifies other PCAOB rules and standards related to the audit that require communication of specific matters between the auditor and the audit committee.

- Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, paragraphs 60, 62, and 64
- Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* paragraphs 78-81, 91, C7, and C14
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, paragraphs 5.f. and 54-57
- PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*
- PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting*
- PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*
- AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* paragraphs .79-.81
- AU sec. 317, *Illegal Acts by Clients*, paragraphs .08, .17, and .20
- AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*, paragraphs 4-7 and 9
- AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, paragraph .50
- AU sec. 333, *Management Representations*, paragraph .05
- AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, paragraphs .04 and .06
- AU sec. 711, *Filings Under Federal Securities Statutes*, paragraph .13
- AU sec. 722, *Interim Financial Information*, paragraphs .08-.09, .30-.31, and .33-.36

Appendix C

Matters Included in the Audit Engagement Letter

C1. The auditor should include the following matters in the engagement letter.[1] The auditor's description of these matters will vary depending on whether the auditor is engaged in a financial statement audit or in an audit of internal control over financial reporting that is integrated with an audit of financial statements ("integrated audit").

a. The objective of the audit is:

1. Integrated audit: The expression of an opinion on both the effectiveness of internal control over financial reporting and the financial statements.
2. Audit of financial statements: The expression of an opinion on the financial statements.

b. Auditor's responsibilities:

1. The auditor is responsible for conducting the audit in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that the auditor:

a. Integrated audit: Plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether effective internal control over financial reporting was maintained in all material respects. Accordingly, there is some risk that a material misstatement of the financial statements or a material weakness in internal control over financial reporting would remain undetected. Although not absolute assurance, reasonable assurance is a high level of assurance.

Also, an integrated audit is not designed to detect error or fraud that is immaterial to the financial statements or deficiencies in internal control over financial reporting that, individually or in combination, are less severe than a material weakness. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

b. Audit of financial statements: Plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, there is some risk that a material misstatement would remain undetected.

[1] Certain matters should not be included in an engagement letter; for example, under Securities and Exchange Commission, *Section 602.02.f.i. of the Codification of Financial Reporting Policies*, indemnification provisions are not permissible for audits of issuers.

Although not absolute assurance, reasonable assurance is a high level of assurance. Also, a financial statement audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

2. An audit includes:
    a. Integrated audit: In fulfillment of the responsibilities noted above, the auditor communicates:
        1. To the audit committee and management: all material weaknesses in internal control over financial reporting identified during the audit, in writing.
        2. To the audit committee: all significant deficiencies identified during the audit, in writing, and informs the audit committee when the auditor has informed management of all internal control deficiencies.
        3. To management: all internal control deficiencies identified during the audit and not previously communicated in writing by the auditor or by others, including internal auditors or others within the company.
        4. To the board of directors: any conclusion that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective, in writing.
    b. Audit of financial statements: Obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed.[2] An audit of financial statements is not designed to provide assurance on internal control or to identify internal control deficiencies. However, the auditor is responsible for communicating:
        1. To the audit committee and management: all significant deficiencies and material weaknesses identified during the audit, in writing.
        2. To the board of directors: if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial

[2] AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*, provides direction on control deficiencies identified in an audit of financial statements.

reporting by the audit committee is ineffective, that conclusion, in writing.

c. Management's responsibilities:

1. Management is responsible for the company's financial statements, including disclosures.
2. Management is responsible for establishing and maintaining effective internal control over financial reporting.
3. Management is responsible for identifying and ensuring that the company complies with the laws and regulations applicable to its activities.
4. Management is responsible for making all financial records and relevant information available to the auditor.
5. At the conclusion of the engagement, management will provide the auditor with a letter that confirms certain representations made during the audit.
6. Management is responsible for adjusting the financial statements to correct material misstatements relating to accounts or disclosures and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

C2. In connection with a review of interim financial information, to confirm and document the understanding, the auditor should either: (a) document in the audit engagement letter the nature and objectives of the engagement to review interim financial information and the responsibilities of management and the auditor or (b) issue a separate engagement letter that addresses such matters.[3]

[3] Paragraphs .08-.09 of AU sec. 722, *Interim Financial Information*, discuss the auditor's responsibilities related to establishing an understanding with the audit committee in connection with a review of the company's interim financial information.

Attachment

PCAOB Release No. 2012-004

August 15, 2012
PCAOB Rulemaking
Docket Matter No. 030

Summary

The Public Company Accounting Oversight Board ("PCAOB" or the "Board") is adopting (i) Auditing Standard No. 16, *Communications with Audit Committees*, that would supersede the Board's interim standards AU sec. 380, *Communication With Audit Committees*, and AU sec. 310, *Appointment of the Independent Auditor*, (ii) transitional amendments to AU sec. 380, and (iii) related amendments to PCAOB standards.

Board Contacts

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* * * * *

I. Introduction

With the passage of the Sarbanes-Oxley Act of 2002 (the "Act") and the establishment of the PCAOB, Congress acknowledged that auditors play an important role in protecting the interests of investors by preparing and issuing informative, accurate, and independent audit reports.[1] The audit committee[2] also plays an important role in protecting the interests of investors by assisting the board of directors in fulfilling its responsibility to a company's shareholders and others to oversee the integrity of a company's accounting and financial reporting processes and audits. The audit committee, among other things, serves as the board of director's principal interface with the company's auditors and facilitates communications between the company's board of directors, its management, and its independent auditors on significant accounting issues and policies. The roles of auditors and audit committees are critical to the efficiency and integrity of the capital markets.

Both the auditor and the audit committee benefit from a meaningful exchange of information regarding significant risks of material misstatement in the financial statements and other matters that may affect the integrity of the company's financial reports. Communications between the auditor and the audit

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[1] *See* Section 101(a) of the Act, 15 U.S.C. §7211(a); Senate Report No. 107-206, at 5-6 (July 3, 2002).

[2] The term "audit committee," as defined in Auditing Standard No. 16, is a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to a company, the entire board of directors of the company. For audits of nonissuers, if no such committee or board of directors (or equivalent body) exists with respect to the company, the person(s) who oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.

committee allow the audit committee to be well-informed about accounting and disclosure matters, including the auditor's evaluation of matters that are significant to the financial statements, and to be better able to carry out its oversight role. Communications with the audit committee provide auditors with a forum separate from management to discuss matters about the audit and the company's financial reporting process.

The Board is adopting Auditing Standard No. 16, *Communications with Audit Committees* (the "standard"), and related amendments to improve the audit by enhancing communications between auditors and audit committees. Auditing Standard No. 16 will replace interim standards AU sec. 380, *Communication With Audit Committees* ("AU sec. 380"), and AU sec. 310, *Appointment of the Independent Auditor* ("AU sec. 310"). Adoption of the standard is in the public interest because the standard establishes requirements that enhance the relevance, timeliness, and quality of the communications between the auditor and the audit committee. The enhanced relevance, timeliness, and quality of communications should facilitate audit committees' financial reporting oversight, fostering improved financial reporting, thereby benefitting investors.

Auditing Standard No. 16 is aligned with the requirements of the Act. For many public companies, the Act served to strengthen and expand the role of the audit committee in the financial reporting process. For example, the Act requires that audit committee members of listed companies be independent and that audit committees be responsible for the appointment, compensation, and oversight of the work of the external auditor for the purpose of preparing or issuing an audit report or related work.[3] These requirements place the audit committee at the center of the relationship between management of a public company and its auditor.

Auditing Standard No. 16 is intended to improve the audit[4] by fostering constructive dialogue between the auditor and the audit committee about significant audit and financial statement matters. The standard requires the auditor to communicate certain matters regarding the audit and the financial statements to the audit committee, which should assist the audit committee in fulfilling its oversight responsibilities regarding the financial reporting process. Effective two-way communication between the auditor and the audit committee on such relevant matters also will benefit the auditor in performing an effective audit.

Auditing Standard No. 16 encourages effective two-way communication between the auditor and the audit committee throughout the audit to assist both parties in understanding matters relevant to the audit. Communications that are tailored to the circumstances and informative, rather than "boiler-plate" or standardized, will enable the auditor and the audit committee to engage in a dialogue that is more likely to benefit both the audit committee, in conducting its oversight responsibilities, and the auditor, in conducting an effective audit. Effective communication between the auditor and the audit committee may involve many forms of communication, such as presentations, charts, written reports, or robust discussions.

AU sec. 380, which became effective in January 1989, indicated that audit committee communications are incidental to the audit and are not required to occur

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[3] *See* Section 301 of the Act and Section 10A(m)(2) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §78j-1(m)(2).

[4] For purposes of this release and standard, an audit is either an audit of internal control over financial reporting that is integrated with an audit of financial statements or an audit of financial statements only.

prior to the issuance of the auditor's report. In contrast, Auditing Standard No. 16 recognizes the importance of the auditor's communications with the audit committee in today's business and regulatory environment; therefore, Auditing Standard No. 16 requires the auditor to communicate the audit strategy and results of the audit to the audit committee in a timely manner and prior to the issuance of the auditor's report to provide an opportunity for the audit committee and the auditor to take appropriate action to address the matters communicated.

Timely communications with the audit committee help the auditor improve the audit by, among other things (i) informing the audit committee, which has responsibility for the oversight of financial reporting, about significant matters related to the audit and the financial statements, (ii) enabling the auditor to obtain the audit committee's insights and information about transactions and events, (iii) enabling the auditor to learn about complaints regarding accounting or auditing matters, and (iv) assisting the auditor in gaining a better understanding of the company and its control environment.

Auditing Standard No. 16 generally links the new communication requirements to the results of related audit performance requirements in other PCAOB standards, or the conduct of the audit. The standard does not otherwise impose new performance requirements, other than communications. Because other PCAOB standards already require the auditor to perform procedures underlying the communications required in Auditing Standard No. 16, and the standard primarily requires communication of the results of the auditor's procedures, the Board does not anticipate a significant increase in cost as a result of the implementation of the standard.

Some of the matters to be communicated under Auditing Standard No. 16 relate specifically to matters involving management's preparation of the company's financial statements. In many companies, management might communicate these matters or take the lead on communicating these matters to the audit committee. The PCAOB does not have the authority to require management to communicate to the audit committee. Additionally, certain communications by the auditor are mandated by federal securities laws and Securities and Exchange Commission ("SEC") rules.[5] Therefore, Auditing Standard No. 16 establishes required communications by the auditor to the audit committee but, at the same time, clearly recognizes and acknowledges that management might communicate to the audit committee certain matters related to the company's financial statements. In such circumstances, the auditor does not need to communicate those matters at the same level of detail as management, as long as certain conditions are met, as specified in the standard.

Auditing Standard No. 16 is scalable for audits of companies of various sizes and complexities. A company's size and complexity might affect the risks of misstatements, the audit strategy, and other significant matters that warrant the attention of the audit committee. Based on the specific company's circumstances, the standard requires communications only to the extent that the matters are relevant to the audit of the financial statements of the company or of internal control over financial reporting. For example, an auditor of a smaller, less complex company with fewer difficult auditing or financial reporting issues may have fewer matters to communicate than the auditor of a larger, more complex company.

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[5] *See e.g*, Section 10A(k) of the Exchange Act, 15 U.S.C. §78j-1(k); SEC Rule 2-07 of Regulation S-X ("SEC Rule 2-07"), 17 C.F.R. §210.2-07; and Rule 10A-3 under the Exchange Act, 17 C.F.R. §240.10A-3.

II. Background

On March 29, 2010, the Board proposed a standard, *Communications with Audit Committees* (the "original proposed standard"), to improve the audit by enhancing the relevance and effectiveness of the communications between the auditor and the audit committee.[6] The original proposed standard was informed by, among other things, the increased use of risk-based audit methodologies, the emphasis on judgments and estimates in the financial reporting frameworks and discussions with the Board's Standing Advisory Group ("SAG").[7]

The Board received 35 comment letters on the original proposed standard.[8] Most commenters were supportive of the original proposed standard, although several commenters suggested that additional outreach to stakeholders might be beneficial. The comments were discussed with the SAG on July 15, 2010.[9] Additionally, on September 21, 2010, the Board held a roundtable[10] to obtain insight from additional stakeholders, including investors, audit committee members, auditors, and preparers.[11] The roundtable discussion explored many key issues that commenters had raised in response to the original proposed standard regarding:

i. Communications beneficial to audit committees;

ii. Accounting policies, practices, and estimates;

iii. Effective two-way communication between the auditor and the audit committee;

iv. Balance between written and oral communications;

v. Audit committee responsibilities in the engagement letter;

vi. Management communications; and

vii. Uncorrected misstatements.

To provide all interested parties with an opportunity for additional comments on the topics discussed at the roundtable, the Board reopened the public comment period on the original proposed standard. The Board received nine additional comment letters during this extended comment period.[12]

The original proposed standard was revised in response to comments received in comment letters and at the roundtable, and discussions with the SAG. The Board reproposed the standard for public comment on December 20, 2011 (the "reproposed standard") to seek comment on:[13]

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[6] *Proposed Auditing Standard Related to Communications with Audit Committees and Related Amendments to Certain PCAOB Auditing Standards*, PCAOB Release No. 2010-001 (March 29, 2010).

[7] The SAG discussed the audit committee communications standard at a number of its meetings, including meetings on: June 21-22, 2004, June 8, 2005, October 5-6, 2005, and October 14-15, 2009.

[8] Comments on the original proposed standard are available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket030Comments.aspx.

[9] A transcript of the portion of the meeting related to the original proposed standard is available at http://pcaobus.org/Rules/Rulemaking/Docket030/Communications_with_Audit_Committees.pdf.

[10] A listing of the roundtable participants is available at http://pcaobus.org/News/Releases/Pages/09162010_RoundtableParticipants.aspx.

[11] A transcript of the roundtable is available at http://pcaobus.org/Rules/Rulemaking/Docket030/Roundtable_Transcript.pdf.

[12] Comments on the original proposed standard are available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket030Comments.aspx.

[13] *Proposed Auditing Standard Related to Communications with Audit Committees; Related Amendments to PCAOB Standards; and Transitional Amendments to AU sec. 380*, PCAOB Release No. 2011-008 (Dec. 20, 2011).

- The revisions to the original proposed standard to align many of the audit committee communication requirements with the auditor performance requirements included in the risk assessment standards, which were adopted subsequent to the issuance of the original proposed standard;
- The applicability of the proposed standard to the audits of brokers and dealers; and
- The addition of the requirement to communicate significant unusual transactions to the audit committee and to communicate the auditor's understanding of the business rationale for such transactions.

The Board received 39 comment letters in response to the reproposed standard.[14] Commenters to the reproposed standard generally were supportive of the changes made to the original proposed standard to enhance the communications between the auditor and the audit committee. Commenters indicated that the changes made enhanced the quality of information exchanged between the auditor and the audit committee. Commenters also indicated that fuller and more relevant communications between the auditor and the audit committee would enable the audit committee to effectively fulfill its oversight responsibilities regarding the financial reporting process, and allow the auditor to perform a more informed, and thus more efficient and effective, audit.

Commenters on the reproposed standard specifically commented on, among other things, the following matters:

- The definition of audit committee in relation to nonissuers without an audit committee or board of directors;
- Management's communication of significant unusual transactions;
- The communication of the auditor's evaluation of the company's ability to continue as a going concern; and
- The application of the standard to the audits of brokers and dealers.

The Board took all comments received during this standard-setting project into consideration in revising the standard. The definition of audit committee was retained substantially in the form as reproposed, with additional clarification provided in Appendix 4 of this release. Auditing Standard No. 16 was revised to acknowledge that management might communicate certain matters related to significant unusual transactions and that the auditor would not have to communicate such matters at the same level of detail as long as certain criteria within the standard are met. Additionally, communication requirements related to the auditor's evaluation of the company's ability to continue as a going concern were revised to align the communications more precisely with the auditor's procedures related to such evaluation. Section IV below discusses the application of Auditing Standard No. 16 to the audits of brokers and dealers.

Significant comments received regarding the reproposed standard are addressed in detail in Appendix 4 of this release.

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[14] Comments on the reproposed standard are available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket030Comments.aspx.

III. Overview of Auditing Standard No. 16

Auditing Standard No. 16 provides a definition of audit committee, retains or enhances existing communication requirements, incorporates certain SEC auditor communication requirements to audit committees, and adds new communication requirements that are generally linked to performance requirements in other PCAOB standards.

For audits of issuers, Auditing Standard No. 16 incorporates the Act's definition of audit committee as a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to the company, then the audit committee is the entire board of directors of the company. For audits of nonissuers, the definition of audit committee contained in Auditing Standard No. 16 provides that if no audit committee or board of directors (or equivalent body) exists with respect to the company, then the audit committee is the person(s) who oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.

AU sec. 310 requires the auditor to establish an understanding with the client regarding the services to be performed. Auditing Standard No. 16 requires the auditor to establish the understanding of the terms of the audit engagement with the audit committee. This requirement aligns the auditing standard with the provision of the Act that requires the audit committee of listed companies to be responsible for the appointment of the external auditor.[15]

Additionally, Auditing Standard No. 16 requires the auditor to record the terms of the engagement in an engagement letter and to have the engagement letter executed by the appropriate party or parties on behalf of the company and determine that the audit committee has acknowledged and agreed to the terms. These requirements are an expansion of the requirement in AU sec. 310 for the auditor to document the understanding in the working papers, preferably through a written communication with the client.

Auditing Standard No. 16 retains many of the communication requirements in AU sec. 380 and also incorporates the SEC communication requirements.[16] The standard improves the current communication requirements of AU sec. 380 by requiring the communications with the audit committee to occur before the issuance of the audit report. Additionally, the standard enhances certain existing auditor communication requirements by requiring the auditor to communicate:

- Certain matters regarding the company's accounting policies, practices, and estimates;
- The auditor's evaluation of the quality of the company's financial reporting;
- Information related to significant unusual transactions, including the business rationale for such transactions; and
- The auditor's views regarding significant accounting or auditing matters when the auditor is aware that management consulted with other accountants about such matters and the auditor has identified a concern regarding these matters.

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[15] *See* Section 301 of the Act, and Sections 10A(m)(2) of the Exchange Act, 15 U.S.C. §78j-1(m)(2).

[16] *See* Section 10A(k) of the Exchange Act, 15 U.S.C. §78j-1(k) and SEC Rule 2-07(a)(1)-(3).

Auditing Standard No. 16 expands the inquiries of the audit committee required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* which requires the auditor to inquire of the audit committee regarding the matters important to the identification and assessment of risks of material misstatement and fraud risks. The additional inquiries in Auditing Standard No. 16 address whether the audit committee is aware of matters relevant to the audit, including, but not limited to, violations or possible violations of laws or regulations.

Additionally, Auditing Standard No. 16 adds new communication requirements that provide the audit committee with additional information about significant aspects of the audit. These communications are generally linked to the results of the audit procedures or the conduct of the audit. Under Auditing Standard No. 16 the auditor would be required to communicate:

- An overview of the overall audit strategy, including timing of the audit, significant risks the auditor identified, and significant changes to the planned audit strategy or identified risks;
- Information about the nature and extent of specialized skill or knowledge needed in the audit, the extent of the planned use of internal auditors, company personnel or other third parties, and other independent public accounting firms, or other persons not employed by the auditor that are involved in the audit;
- The basis for the auditor's determination that he or she can serve as principal auditor, if significant parts of the audit will be performed by other auditors;
- Situations in which the auditor identified a concern regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting;
- Difficult or contentious matters for which the auditor consulted outside the engagement team;
- The auditor's evaluation of going concern;
- Departure from the auditor's standard report; and
- Other matters arising from the audit that are significant to the oversight of the company's financial reporting process, including complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit.

In addition to the communication requirements included in Auditing Standard No. 16, other PCAOB standards and rules that require the auditor to communicate specific matters to the audit committee are referenced in Appendix B to Auditing Standard No. 16.

While the standard establishes certain requirements regarding auditor communications to the audit committee, Auditing Standard No. 16 does not preclude the auditor from providing additional information to the audit committee. Nor does the standard preclude the auditor from responding to audit committee requests for additional information from the auditor.

IV. Audits of Brokers and Dealers

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[17] gave the Board oversight of the audits of brokers and dealers registered with the SEC. In September 2010, the Commission issued interpretive guidance clarifying that the references in Commission rules and staff guidance and in the federal securities laws to generally accepted auditing standards ("GAAS") or to specific standards under GAAS, as they relate to nonissuer brokers or dealers, should continue to be understood to mean the auditing and attestation standards established by the American Institute of Certified Public Accountants ("AICPA"), but noted that it intended to revisit this interpretation in connection with a SEC rulemaking project to update the audit and attestation requirements for brokers and dealers in light of the Dodd-Frank Act.[18] On June 15, 2011, the SEC proposed to amend its rules, including SEC Rule 17a-5 under the Exchange Act, to require, among other things, that audits of brokers' and dealers' financial statements and examinations of reports regarding compliance with SEC requirements be performed in accordance with the standards of the PCAOB.[19]

If the SEC adopts its proposed amendments to SEC Rule 17a-5 or provides other direction that auditors of brokers and dealers are to comply with PCAOB professional standards, the Board's auditing, attestation, quality control, and, where applicable, independence standards would then apply to audits of brokers and dealers as required by Section 17 of the Exchange Act and SEC Rule 17a-5.[20]

Further, if the SEC adopts its proposed amendments to SEC Rule 17a-5 or provides other direction that auditors of brokers and dealers are to comply with PCAOB standards, prior to the effective date of Auditing Standard No. 16,[21] the Board's interim standard, AU sec. 380, would be in effect for audits of brokers and dealers conducted for periods prior to the effective date of Auditing Standard No. 16. The Board's interim standard, AU sec. 380, which was last amended in 1999, indicates that it is not applicable to the audit of a broker or dealer if the broker or dealer does not have an audit committee[22] or is registered with the SEC only because of Section 15(a) of the Exchange Act.[23] Conversely, the auditor communication requirements under GAAS, which are contained in Statement on Auditing Standards ("SAS") 114, *The Auditor's Communication With Those Charged With Governance,* which was issued by the Auditing Standards Board ("ASB") of the AICPA in 2006, are applicable to audits of all brokers

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[17] Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

[18] SEC, *Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers*, Exchange Act Release No. 62991 (Sept. 24, 2010).

[19] SEC, *Broker-Dealer Reports,* Exchange Act Release No. 64676 (June 15, 2011).

[20] 17 C.F.R. § 240.17a-5.

[21] As noted in Section VII of this release, the Board anticipates that Auditing Standard No. 16 will be effective, subject to SEC approval, for audits of fiscal years beginning on or after December 15, 2012.

[22] AU sec. 380.01 states that the communications required by AU sec. 380 are applicable to entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee).

[23] *See* AU sec. 380.01, which states that the communications required by the standard "are applicable to . . . all Securities and Exchange Commission (SEC) engagements." As noted in footnote 2 to AU sec. 380.01, the audits of brokers and dealers do not fall within an SEC engagement as defined in AU sec. 380 if the broker or dealer is registered only because of Section 15(a) of the Exchange Act.

and dealers.[24] Because of this difference in the applicability of the auditor communication standards to the audits of brokers and dealers, there could be a gap in required audit committee communications if the SEC amendments to SEC Rule 17a-5 are adopted and become effective prior to the effective date of Auditing Standard No. 16. To eliminate this gap, the Board is amending AU sec. 380 to delete the current exception for audits of brokers and dealers that do not have an audit committee or are registered with the SEC only because of Section 15(a) of the Exchange Act. The transitional amendment, which is contained in Appendix 2 to this release, would eliminate the above-referenced gap in audit committee communications by making the communication requirements in AU sec. 380 applicable to audits of issuers and brokers and dealers, as those terms are defined in the Act, prior to the effective date of Auditing Standard No. 16.

If PCAOB standards are applicable to audits of brokers and dealers prior to the effective date of Auditing Standard No. 16, the communication requirements under Auditing Standard No. 16 would be applicable to the audits of brokers and dealers upon the effective date of the standard.

V. Emerging Growth Companies

Pursuant to Section 104 of the Jumpstart Our Business Startups Act ("JOBS Act"), any rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of emerging growth companies ("EGCs") (as defined in Section 3(a)(80) of the Exchange Act) unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."[25] Auditing Standard No. 16 is the first auditing standard adopted by the Board subsequent to enactment of the JOBS Act and accordingly is subject to a separate determination by the SEC regarding its applicability to audits of EGCs.

Pursuant to Section 107(b) of the Act, the Board will file Auditing Standard No. 16 for approval by the SEC. The Board will also request that the SEC approve the application of Auditing Standard No. 16, and the related amendments, to the audits of EGCs.

VI. Appendices

Appendix 1 to this release contains the text of Auditing Standard No. 16, *Communications with Audit Committees,* which has three appendices:

(1) Appendix A—Definitions,

(2) Appendix B—Communications with Audit Committees Required by Other PCAOB Rules and Standards, and

(3) Appendix C—Matters Included in the Audit Engagement Letter.

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[24] *See* paragraph 1 of SAS 114 which states "[t]his statement . . . establishes standards and provides guidance on the auditor's communication with those charged with governance in relation to an audit of financial statements," and section 5.129 of the *AICPA Audit & Accounting Guide: Brokers and Dealers in Securities* (July 2010), which states, in part: "AU section 380, *The Auditor's Communication with Those Charged with Governance* . . . has been updated for the issuance of SAS No. 114. . . . AU 380 is applicable to all broker-dealers being audited under GAAS, regardless of their governance structure or size."

[25] Pub. L. No. 112-106, 126 STAT. 306 (April 5, 2012). *See* Section 103(a)(3)(C) of the Act, 15 U.S.C. §7213 (a)(3)(C), as added by Section 104 of the JOBS Act.

Appendix 2 to this release contains the transitional amendments to AU sec. 380. Appendix 3 to this release contains amendments to other existing PCAOB standards. Appendix 4 provides additional discussion of Auditing Standard No. 16, the amendments to other PCAOB standards, and comments received on the reproposed standard. Appendix 5 to this release discusses certain significant differences between the objectives and requirements of Auditing Standard No. 16 and the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board of the AICPA. In developing the standard, the Board considered the requirements of the relevant standards of the IAASB and the ASB.

VII. Effective Date

The Board anticipates that the transitional amendments to AU sec. 380 included in Appendix 2 would be effective, subject to SEC approval, for the periods that PCAOB standards become applicable to audits of brokers and dealers, as designated by the SEC upon adoption of its amendments to SEC Rule 17a-5, if such periods precede the effective date of Auditing Standard No. 16.

The Board anticipates that Auditing Standard No. 16 and related amendments, included in Appendices 1 and 3, respectively, will be effective, subject to SEC approval, for audits of fiscal years beginning on or after December 15, 2012.

On the 15th day of August, in the year 2012, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ Phoebe W. Brown
Phoebe W. Brown
Secretary

Appendix 1

Auditing Standard No. 16, *Communications with Audit Committees*

[Appendix omitted; see Auditing Standard No. 16 for the full text of the standard.]

Appendix 2

Transitional Amendments to AU sec. 380, Communication With Audit Committees

[Appendix omitted; see appendix 2 in PCAOB Release No. 2012-004 for a list of the amendments.]

Appendix 3

Amendments to PCAOB Standards

[Appendix omitted; see appendix 3 in PCAOB Release No. 2012-004 for a list of the amendments.]

Appendix 4

Additional Discussion of Auditing Standard No. 16, Related Amendments to PCAOB Standards, and Comments on the Reproposed Standard

[Appendix omitted; see appendix 4 in PCAOB Release No. 2012-004 for a full analysis.]

Appendix 5

Comparison of the Objectives and Requirements of Auditing Standard No. 16, *Communications with Audit Committees*, to the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

[Appendix omitted; see appendix 5 in PCAOB Release No. 2012-004 for a full analysis.]

AUDITING STANDARDS TOPICAL INDEX

References are to Auditing Standard section and paragraph numbers.

A

C

D

E

R

S

T

Interim Standards

References to GAAS

PCAOB Auditing Standard No. 1 (PCAOB Release No. 2003-025) supersedes all references in the PCAOB interim standards to generally accepted auditing standards, U.S. generally accepted auditing standards, auditing standards generally accepted in the United States of America, and standards established by the AICPA. It also requires that auditor's reports on the financial statements of issuers that are issued or reissued after the effective date of Auditing Standard No. 1 (AS 1) include a statement that the engagement was conducted in accordance with "the standards of the Public Company Accounting Oversight Board (United States)."

The AICPA has not made conforming changes to the PCAOB's Interim Professional Auditing Standards (which are contained in this section) to reflect this requirement and intent of AS 1 issued by the PCAOB and approved by the Securities and Exchange Commission. AS 1 should be followed where there are conflicts between AS 1 and the PCAOB's Interim Professional Auditing Standards. Such conforming changes will be made when the PCAOB issues a rule or standard that identifies and makes such changes.

AU Section 100

STATEMENTS ON AUDITING STANDARDS—INTRODUCTION

TABLE OF CONTENTS

AU Section 110

Responsibilities and Functions of the Independent Auditor

Source: SAS No. 1, section 110; SAS No. 78; SAS No. 82; Auditing Standard Nos. 8–15.

Issue date, unless otherwise indicated: November, 1972.

.01 The objective of the ordinary audit of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles. The auditor's report is the medium through which he expresses his opinion or, if circumstances require, disclaims an opinion. In either case, he states whether his audit has been made in accordance with generally accepted auditing standards. These standards require him to state whether, in his opinion, the financial statements are presented in conformity with generally accepted accounting principles and to identify those circumstances in which such principles have not been consistently observed in the preparation of the financial statements of the current period in relation to those of the preceding period.

Distinction Between Responsibilities of Auditor and Management

.02 The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.[1] Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected.[2] The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.03 The financial statements are management's responsibility. The auditor's responsibility is to express an opinion on the financial statements. Management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, initiate, record, process, and report transactions (as well as events and conditions) consistent

[1] See Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*. The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in section 317, *Illegal Acts by Clients*. For those illegal acts that are defined in that section as having a direct and material effect on the determination of financial statement amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts is the same as that for error or fraud. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[2] See section 230, *Due Professional Care in the Performance of Work*, paragraphs .10 through .13. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

with management's assertions embodied in the financial statements. The entity's transactions and the related assets, liabilities, and equity are within the direct knowledge and control of management. The auditor's knowledge of these matters and internal control is limited to that acquired through the audit. Thus, the fair presentation of financial statements in conformity with generally accepted accounting principles[3] is an implicit and integral part of management's responsibility. The independent auditor may make suggestions about the form or content of the financial statements or draft them, in whole or in part, based on information from management during the performance of the audit. However, the auditor's responsibility for the financial statements he or she has audited is confined to the expression of his or her opinion on them. [Revised, April 1989, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. As amended, effective for audits of financial statements for periods beginning on or after January 1, 1997, by Statement on Auditing Standards No. 78. Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997. Revised, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

Professional Qualifications

.04 The professional qualifications required of the independent auditor are those of a person with the education and experience to practice as such. They do not include those of a person trained for or qualified to engage in another profession or occupation. For example, the independent auditor, in observing the taking of a physical inventory, does not purport to act as an appraiser, a valuer, or an expert in materials. Similarly, although the independent auditor is informed in a general manner about matters of commercial law, he does not purport to act in the capacity of a lawyer and may appropriately rely upon the advice of attorneys in all matters of law. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.05 In the observance of generally accepted auditing standards, the independent auditor must exercise his judgment in determining which auditing procedures are necessary in the circumstances to afford a reasonable basis for his opinion. His judgment is required to be the informed judgment of a qualified professional person. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

Detection of Fraud

[.06–.09] [Superseded January 1977 by Statement on Auditing Standards No. 16, as superseded by Statement on Auditing Standards No. 53, as superseded by section 316. Paragraphs renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

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[3] The responsibilities and functions of the independent auditor are also applicable to financial statements presented in conformity with a comprehensive basis of accounting other than generally accepted accounting principles; references in this section to financial statements presented in conformity with generally accepted accounting principles also include those presentations. [Footnote added, effective for audits of financial statements for periods beginning on or after January 1, 1997, by Statement on Auditing Standards No. 78. Footnote renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

Responsibility to the Profession

.10 The independent auditor also has a responsibility to his profession, the responsibility to comply with the standards accepted by his fellow practitioners. In recognition of the importance of such compliance, the American Institute of Certified Public Accountants has adopted, as part of its Code of Professional Conduct, rules which support the standards and provide a basis for their enforcement. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

AU Section 150

Generally Accepted Auditing Standards

(Supersedes SAS No. 1, section 150)

Source: SAS No. 95; SAS No. 98; Auditing Standard Nos. 8–15.

Effective for audits of financial statements for periods beginning on or after December 15, 2001, unless otherwise indicated.

.01 An independent auditor plans, conducts, and reports the results of an audit in accordance with generally accepted auditing standards (GAAS). Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit. Auditing procedures differ from auditing standards. Auditing procedures are acts that the auditor performs during the course of an audit to comply with auditing standards.

Auditing Standards

.02 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The general, field work, and reporting standards (the 10 standards) approved and adopted by the membership of the AICPA, as amended by the AICPA Auditing Standards Board (ASB), are as follows:

General Standards

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
3. Sufficient appropriate evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

.03 Rule 202, *Compliance With Standards*, of the AICPA Code of Professional Conduct [ET section 202.01], requires an AICPA member who performs an audit (the auditor) to comply with standards promulgated by the ASB.[1] The ASB develops and issues standards in the form of Statements on Auditing Standards (SASs) through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs are codified within the framework of the 10 standards.

.04 The auditor should have sufficient knowledge of the SASs to identify those that are applicable to his or her audit. The nature of the 10 standards and the SASs requires the auditor to exercise professional judgment in applying them. Materiality and audit risk also underlie the application of the 10 standards and the SASs, particularly those related to field work and reporting.[2] The auditor should be prepared to justify departures from the SASs.

Interpretive Publications

.05 *Interpretive publications* consist of auditing Interpretations of the SASs, appendixes to the SASs,[3] auditing guidance included in AICPA Audit and Accounting Guides, and AICPA auditing Statements of Position.[4] Interpretive publications are not auditing standards. Interpretive publications are recommendations on the application of the SASs in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued under the authority of the ASB after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the SASs. [As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.06 The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

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[1] In certain engagements, the auditor also may be subject to other auditing requirements, such as Government Auditing Standards issued by the comptroller general of the United States, or rules and regulations promulgated by the U.S. Securities and Exchange Commission.

[2] *[Footnote deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[3] Appendixes to SASs referred to in paragraph .05 of this section do not include previously issued appendixes to original pronouncements that when adopted modified other SASs. [Footnote added, effective September 2002, by Statement on Auditing Standards No. 98.]

[4] Auditing Interpretations of the SASs are included in the codified version of the SASs and are cross-referenced from the related AU sections in Appendix C. AICPA Audit and Accounting Guides and auditing Statements of Position are listed in Appendix D. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

Other Auditing Publications

.07 *Other auditing publications* include AICPA auditing publications not referred to above; auditing articles in the *Journal of Accountancy* and other professional journals; auditing articles in the AICPA *CPA Letter*; continuing professional education programs and other instruction materials, textbooks, guide books, audit programs, and checklists; and other auditing publications from state CPA societies, other organizations, and individuals.[5] Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the SASs.

.08 If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit, and appropriate. In determining whether an other auditing publication is appropriate, the auditor may wish to consider the degree to which the publication is recognized as being helpful in understanding and applying the SASs and the degree to which the issuer or author is recognized as an authority in auditing matters. Other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are presumed to be appropriate.[6]

Effective Date

.09 This section is effective for audits of financial statements for periods beginning on or after December 15, 2001.

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[5] The auditor is not expected to be aware of the full body of other auditing publications. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

[6] Other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are listed in AU Appendix F. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

AU Section 161

The Relationship of Generally Accepted Auditing Standards to Quality Control Standards

(Supersedes SAS No. 4)[1]

Source: SAS No. 25; SAS No. 98.

Issue date, unless otherwise indicated: November, 1979.

.01 The independent auditor is responsible for compliance with generally accepted auditing standards in an audit engagement. Rule 202 [ET section 202.01] of the Rules of Conduct of the Code of Professional Conduct of the American Institute of Certified Public Accountants requires members to comply with such standards when associated with financial statements.

.02 A firm of independent auditors has a responsibility to adopt a system of quality control in conducting an audit practice.[2] Thus, a firm should establish quality control policies and procedures to provide it with reasonable assurance that its personnel comply with generally accepted auditing standards in its audit engagements. The nature and extent of a firm's quality control policies and procedures depend on factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations. [Revised, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 96. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.03 Generally accepted auditing standards relate to the conduct of individual audit engagements; quality control standards relate to the conduct of a firm's audit practice as a whole. Thus, generally accepted auditing standards and quality control standards are related, and the quality control policies and procedures that a firm adopts may affect both the conduct of individual audit engagements and the conduct of a firm's audit practice as a whole. However, deficiencies in or instances of noncompliance with a firm's quality control policies and procedures do not, in and of themselves, indicate that a particular audit engagement was not performed in accordance with generally accepted auditing standards. [As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

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[1] [Footnote deleted by the issuance of Statement on Auditing Standards No. 98, September 2002.]

[2] The elements of quality control are identified in Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* [QC section 20]. A system of quality control is broadly defined as a process to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality. [Footnote added, effective September 2002, by Statement on Auditing Standards No. 98.]

AU Section 200
THE GENERAL STANDARDS

TABLE OF CONTENTS

AU Section 201

Nature of the General Standards

Source: SAS No. 1, section 201.

Issue date, unless otherwise indicated: November, 1972.

.01 The general standards are personal in nature and are concerned with the qualifications of the auditor and the quality of his work as distinct from those standards which relate to the performance of his field work and to his reporting. These personal, or general, standards apply alike to the areas of field work and reporting.

AU Section 210

Training and Proficiency of the Independent Auditor

Source: SAS No. 1, section 210; SAS No. 5; Auditing Standard Nos. 8–15.

Issue date, unless otherwise indicated: November, 1972.

.01 The first general standard is:

> The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

.02 This standard recognizes that however capable a person may be in other fields, including business and finance, he cannot meet the requirements of the auditing standards without proper education and experience in the field of auditing.

.03 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

In the performance of the audit which leads to an opinion, the independent auditor holds himself out as one who is proficient in accounting and auditing. The attainment of that proficiency begins with the auditor's formal education and extends into his subsequent experience. The independent auditor must undergo training adequate to meet the requirements of a professional. This training must be adequate in technical scope and should include a commensurate measure of general education. The junior assistant, just entering upon an auditing career, must obtain his professional experience with the proper supervision and review of his work by a more experienced superior. The nature and extent of supervision and review must necessarily reflect wide variances in practice. 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.

.04 The independent auditor's formal education and professional experience complement one another; each auditor exercising authority upon an engagement should weigh these attributes in determining the extent of his supervision of subordinates and review of their work. It should be recognized that the training of a professional man includes a continual awareness of developments taking place in business and in his profession. He must study, understand, and apply new pronouncements on accounting principles and auditing procedures as they are developed by authoritative bodies within the accounting profession.

.05 In the course of his day-to-day practice, the independent auditor encounters a wide range of judgment on the part of management, varying from true objective judgment to the occasional extreme of deliberate misstatement. He is retained to audit and report upon the financial statements of a business because, through his training and experience, he has become skilled in accounting and auditing and has acquired the ability to consider objectively and to exercise independent judgment with respect to the information recorded in books of account or otherwise disclosed by his audit. [As amended July, 1975 by Statement on Auditing Standards No. 5.]

AU Section 220
Independence

Source: SAS No. 1, section 220.

Issue date, unless otherwise indicated: November, 1972.

.01 The second general standard is:

> In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

.02 This standard requires that the auditor be independent; aside from being in public practice (as distinct from being in private practice), he must be without bias with respect to the client since otherwise he would lack that impartiality necessary for the dependability of his findings, however excellent his technical proficiency may be. However, independence does not imply the attitude of a prosecutor but rather a judicial impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to creditors and those who may otherwise rely (in part, at least) upon the independent auditor's report, as in the case of prospective owners or creditors.

.03 It is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors. Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. To *be* independent, the auditor must be intellectually honest; to be *recognized* as independent, he must be free from any obligation to or interest in the client, its management, or its owners. For example, an independent auditor auditing a company of which he was also a director might be intellectually honest, but it is unlikely that the public would accept him as independent since he would be in effect auditing decisions which he had a part in making. Likewise, an auditor with a substantial financial interest in a company might be unbiased in expressing his opinion on the financial statements of the company, but the public would be reluctant to believe that he was unbiased. Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence.

.04 The profession has established, through the AICPA's Code of Professional Conduct, precepts to guard against the *presumption* of loss of independence. "Presumption" is stressed because the possession of intrinsic independence is a matter of personal quality rather than of rules that formulate certain objective tests. Insofar as these precepts have been incorporated in the profession's code, they have the force of professional law for the independent auditor.

.05 The Securities and Exchange Commission (SEC) has also adopted requirements for independence of auditors who report on financial statements filed with it that differ from the AICPA requirements in certain respects.[1]

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[1] [Footnote deleted, December 2001, to acknowledge the dissolution of the Independence Standard Board.]

.06 The independent auditor should administer his practice within the spirit of these precepts and rules if he is to achieve a proper degree of independence in the conduct of his work.

.07 To emphasize independence from management, many corporations follow the practice of having the independent auditor appointed by the board of directors or elected by the stockholders.

AU Section 230

*Due Professional Care in the Performance of Work**

Source: SAS No. 1, section 230; SAS No. 41; SAS No. 82; SAS No. 99; Auditing Standard No. 5; Auditing Standard Nos. 8–15.

Issue date, unless otherwise indicated: November, 1972.

.01 The third general standard is:

> Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report.[1]

[As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.02 This standard requires the independent auditor to plan and perform his or her work with due professional care. Due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of field work and reporting. [As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.03 *Cooley on Torts*, a legal treatise, describes the obligation for due care as follows:

> Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all these employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretentions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.[2]

[As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.04 The matter of due professional care concerns what the independent auditor does and how well he or she does it. The quotation from *Cooley on Torts* provides a source from which an auditor's responsibility for conducting an audit with due professional care can be derived. The remainder of the section discusses the auditor's responsibility in the context of an audit. [As amended,

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* [Title amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

[1] This amendment revises the third general standard of the ten generally accepted auditing standards. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

[2] D. Haggard, *Cooley on Torts*, 472 (4th ed., 1932). [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

April 1982, by Statement on Auditing Standards No. 41. As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.05 An auditor should possess "the degree of skill commonly possessed" by other auditors and should exercise it with "reasonable care and diligence" (that is, with due professional care). [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.06 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Auditors should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability so that they can evaluate the audit evidence they are examining.[3] 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.[4] [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

Professional Skepticism

.07 Due professional care requires the auditor to exercise *professional skepticism*. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor uses the knowledge, skill, and ability called for by the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.08 Gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence. Since evidence is gathered and evaluated throughout the audit, professional skepticism should be exercised throughout the audit process. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.09 The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

Reasonable Assurance

.10 *[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]*

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[3] *[Footnote deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[4] See Auditing Standard No. 10, *Supervision of the Audit Engagement*. [*Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The exercise of due professional care allows the auditor to obtain *reasonable assurance* about whether the financial statements are free of material misstatement, whether caused by error or fraud, or whether any material weaknesses exist as of the date of management's assessment. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Although not absolute assurance, reasonable assurance is a high level of assurance. Therefore, an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) may not detect a material weakness in internal control over financial reporting or a material misstatement to the financial statements.

.11 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The independent auditor's objective is to obtain sufficient appropriate evidential matter to provide him or her with a reasonable basis for forming an opinion. The nature of most evidence derives, in part, from the concept of selective testing of the data being audited, which involves judgment regarding both the areas to be tested and the nature, timing, and extent of the tests to be performed. In addition, judgment is required in interpreting the results of audit testing and evaluating audit evidence. Even with good faith and integrity, mistakes and errors in judgment can be made. Furthermore, accounting presentations contain accounting estimates, the measurement of which is inherently uncertain and depends on the outcome of future events. The auditor exercises professional judgment in evaluating the reasonableness of accounting estimates based on information that could reasonably be expected to be available prior to the completion of field work. [5] As a result of these factors, in the great majority of cases, the auditor has to rely on evidence that is persuasive rather than convincing.[6]

.12 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Because of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement. Characteristics of fraud include (*a*) concealment through collusion among management, employees, or third parties; (*b*) withheld, misrepresented, or falsified documentation; and (*c*) the ability of management to override or instruct others to override what otherwise appears to be effective controls. For example, auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion among personnel within the entity and third parties or among management or employees of the entity. Collusion may cause the auditor who has properly performed the audit to conclude that evidence provided is persuasive when it is, in fact, false. In addition, an audit conducted in accordance with generally accepted auditing standards rarely involves authentication of documentation, nor are auditors trained as or expected to be experts in such authentication. (See paragraph 9 of Auditing Standard No. 15, *Audit Evidence*.) Furthermore, an auditor may not discover the existence of a modification of documentation through a side agreement that management or a third party has not disclosed. Finally, management has the ability to directly or indirectly manipulate accounting records and present fraudulent financial information by overriding controls in unpredictable ways.

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[5] See section 342, *Auditing Accounting Estimates*. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

[6] *[Footnote deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

.13 *[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]*

Since the auditor's opinion on the financial statements or internal control over financial reporting is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her report does not constitute a guarantee. Therefore, the subsequent discovery that either a material misstatement, whether from error or fraud, exists in the financial statements or a material weakness in internal control over financial reporting exists does not, in and of itself, evidence (*a*) failure to obtain reasonable assurance, (*b*) inadequate planning, performance, or judgment, (*c*) the absence of due professional care, or (*d*) a failure to comply with the standards of the Public Company Accounting Oversight Board (United States).

AU Section 300
THE STANDARDS OF FIELD WORK

TABLE OF CONTENTS

AU Section 310

Appointment of the Independent Auditor

[This section was superseded, effective December 15, 2012, by PCAOB Auditing Standard No. 16. See PCAOB Release No. 2012-004.]

AU Section 311

Planning and Supervision

[This section was superseded, effective December 15, 2010, by PCAOB Auditing Standard Nos. 8–15. See PCAOB Release No. 2010-004.]

[See Auditing Standard No. 9, Audit Planning*, in the "Auditing Standards" section.]*

AU Section 9311

Planning and Supervision: Auditing Interpretations of Section 311

[This section was superseded, effective December 15, 2010, by PCAOB Auditing Standard Nos. 8–15. See PCAOB Release No. 2010-004.]

AU Section 312

Audit Risk and Materiality in Conducting an Audit

[This section was superseded, effective December 15, 2010, by PCAOB Auditing Standard Nos. 8–15. See PCAOB Release No. 2010-004.]

[See Auditing Standard No. 8, Audit Risk*, in the "Auditing Standards" section.]*

AU Section 9312

Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312

[This section was superseded, effective December 15, 2010, by PCAOB Auditing Standard Nos. 8–15. See PCAOB Release No. 2010-004.]

AU Section 313

Substantive Tests Prior to the Balance Sheet Date

[This section was superseded, effective December 15, 2010, by PCAOB Auditing Standard Nos. 8–15. See PCAOB Release No. 2010-004.]

AU Section 315

Communications Between Predecessor and Successor Auditors

(Supersedes SAS No. 7)

Source: SAS No. 84; SAS No. 93; Auditing Standard No. 5; Auditing Standard Nos. 8–15.

Effective with respect to acceptance of an engagement after March 31, 1998, unless otherwise indicated.

Introduction

.01 This section provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place. It also provides communications guidance when possible misstatements are discovered in financial statements reported on by a predecessor auditor. This section applies whenever an independent auditor is considering accepting an engagement to audit or reaudit (see paragraph .14 of this section) financial statements in accordance with generally accepted auditing standards, and after such auditor has been appointed to perform such an engagement.

.02 For the purposes of this section, the term *predecessor auditor* refers to an auditor who (*a*) has reported on the most recent audited financial statements[1] or was engaged to perform but did not complete an audit of the financial statements[2] and (*b*) has resigned, declined to stand for reappointment, or been notified that his or her services have been, or may be, terminated. The term *successor auditor* refers to an auditor who is considering accepting an engagement to audit financial statements but has not communicated with the predecessor auditor as provided in paragraphs .07 through .10 and to an auditor who has accepted such an engagement. [As amended, effective for audits of financial statements for periods ending on or after June 30, 2001, by Statement on Auditing Standards No. 93.]

Change of Auditors

.03 An auditor should not accept an engagement until the communications described in paragraphs .07 through .10 have been evaluated.[3] However, an

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[1] The provisions of this section are not required if the most recent audited financial statements are more than two years prior to the beginning of the earliest period to be audited by the successor auditor.

[2] There may be two predecessor auditors: the auditor who reported on the most recent audited financial statements and the auditor who was engaged to perform but did not complete an audit of any subsequent financial statements. [As amended, effective for audits of financial statements for periods ending on or after June 30, 2001, by Statement on Auditing Standards No. 93.]

[3] When the most recent financial statements have been compiled or reviewed in accordance with the Statements on Standards for Accounting and Review Services, the accountant who reported on

(continued)

auditor may make a proposal for an audit engagement before communicating with the predecessor auditor. The auditor may wish to advise the prospective client (for example, in a proposal) that acceptance cannot be final until the communications have been evaluated.

.04 Other communications between the successor and predecessor auditors, described in paragraph .11, are advisable to assist in the planning of the engagement. However, the timing of these other communications is more flexible. The successor auditor may initiate these other communications either prior to acceptance of the engagement or subsequent thereto.

.05 When more than one auditor is considering accepting an engagement, the predecessor auditor should not be expected to be available to respond to inquiries until a successor auditor has been selected by the prospective client and has accepted the engagement subject to the evaluation of the communications with the predecessor auditor as provided in paragraphs .07 through .10.

.06 The initiative for communicating rests with the successor auditor. The communication may be either written or oral. Both the predecessor and successor auditors should hold in confidence information obtained from each other. This obligation applies whether or not the successor auditor accepts the engagement.

Communications Before Successor Auditor Accepts Engagement

.07 Inquiry of the predecessor auditor is a necessary procedure because the predecessor auditor may be able to provide information that will assist the successor auditor in determining whether to accept the engagement. The successor auditor should bear in mind that, among other things, the predecessor auditor and the client may have disagreed about accounting principles, auditing procedures, or similarly significant matters.

.08 The successor auditor should request permission from the prospective client to make an inquiry of the predecessor auditor prior to final acceptance of the engagement. Except as permitted by the Rules of the Code of Professional Conduct, an auditor is precluded from disclosing confidential information obtained in the course of an engagement unless the client specifically consents. Thus, the successor auditor should ask the prospective client to authorize the predecessor auditor to respond fully to the successor auditor's inquiries. If a prospective client refuses to permit the predecessor auditor to respond or limits the response, the successor auditor should inquire as to the reasons and consider the implications of that refusal in deciding whether to accept the engagement.

.09 The successor auditor should make specific and reasonable inquiries of the predecessor auditor regarding matters that will assist the successor auditor in determining whether to accept the engagement. Matters subject to inquiry should include—

- Information that might bear on the integrity of management.
- Disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters.

(footnote continued)

those financial statements is not a predecessor auditor. Although not required by this section, in these circumstances the successor auditor may find the matters described in paragraphs .08 and .09 useful in determining whether to accept the engagement.

- Communications to audit committees or others with equivalent authority and responsibility[4] regarding fraud, illegal acts by clients, and internal-control-related matters.[5]
- The predecessor auditor's understanding as to the reasons for the change of auditors.

The successor auditor may wish to consider other reasonable inquiries.

.10 The predecessor auditor should respond promptly and fully, on the basis of known facts, to the successor auditor's reasonable inquiries. However, should the predecessor auditor decide, due to unusual circumstances such as impending, threatened, or potential litigation; disciplinary proceedings; or other unusual circumstances, not to respond fully to the inquiries, the predecessor auditor should clearly state that the response is limited. If the successor auditor receives a limited response, its implications should be considered in deciding whether to accept the engagement.

Other Communications

.11 The successor auditor should request that the client authorize the predecessor auditor to allow a review of the predecessor auditor's working papers. The predecessor auditor may wish to request a consent and acknowledgment letter from the client to document this authorization in an effort to reduce misunderstandings about the scope of the communications being authorized.[6] It is customary in such circumstances for the predecessor auditor to make himself or herself available to the successor auditor and make available for review certain of the working papers. The predecessor auditor should determine which working papers are to be made available for review and which may be copied. The predecessor auditor should ordinarily permit the successor auditor to review working papers, including documentation of planning, internal control, audit results, and other matters of continuing accounting and auditing significance, such as the working paper analysis of balance sheet accounts, and those relating to contingencies. Also, the predecessor auditor should reach an understanding with the successor auditor as to the use of the working papers.[7] The extent, if any, to which a predecessor auditor permits access to the working papers is a matter of judgment.

Successor Auditor's Use of Communications

.12 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The successor auditor must obtain sufficient appropriate evidential matter to afford a reasonable basis for expressing an opinion on the financial statements he or she has been engaged to audit, including evaluating the consistency of the application of accounting principles. The audit evidence used in analyzing the impact of the opening balances on the current-year financial statements

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[4] For entities that do not have audit committees, the phrase "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, or the owner in owner-managed entities.

[5] See section 316, *Consideration of Fraud in a Financial Statement Audit*; section 317, *Illegal Acts by Clients*; and section 325, *Communication of Internal Control Related Matters Noted in an Audit*.

[6] Appendix A [paragraph .24] contains an illustrative client consent and acknowledgment letter.

[7] Before permitting access to the working papers, the predecessor auditor may wish to obtain a written communication from the successor auditor regarding the use of the working papers. Appendix B [paragraph .25] contains an illustrative successor auditor acknowledgment letter.

and consistency of accounting principles is a matter of professional judgment. Such audit evidence may include the most recent audited financial statements, the predecessor auditor's report thereon,[8] the results of inquiry of the predecessor auditor, the results of the successor auditor's review of the predecessor auditor's working papers relating to the most recently completed audit, and audit procedures performed on the current period's transactions that may provide evidence about the opening balances or consistency. For example, evidence gathered during the current year's audit may provide information about the realizability and existence of receivables and inventory recorded at the beginning of the year. The successor auditor may also apply appropriate auditing procedures to account balances at the beginning of the period under audit and to transactions in prior periods.

.13 The successor auditor's review of the predecessor auditor's working papers may affect the nature, timing, and extent of the successor auditor's procedures with respect to the opening balances and consistency of accounting principles. However, the nature, timing, and extent of audit work performed and the conclusions reached in both these areas are solely the responsibility of the successor auditor. In reporting on the audit, the successor auditor should not make reference to the report or work of the predecessor auditor as the basis, in part, for the successor auditor's own opinion.

Audits of Financial Statements That Have Been Previously Audited

.14 If an auditor is asked to audit and report on financial statements that have been previously audited and reported on (henceforth referred to as a reaudit), the auditor considering acceptance of the reaudit engagement is also a successor auditor, and the auditor who previously reported is also a predecessor auditor. In addition to the communications described in paragraphs .07 through .10, the successor auditor should state that the purpose of the inquiries is to obtain information about whether to accept an engagement to perform a reaudit.

.15 If the successor auditor accepts the reaudit engagement, he or she may consider the information obtained from inquiries of the predecessor auditor and review of the predecessor auditor's report and working papers in planning the reaudit. However, the information obtained from those inquiries and any review of the predecessor auditor's report and working papers is not sufficient to afford a basis for expressing an opinion. The nature, timing, and extent of the audit work performed and the conclusions reached in the reaudit are solely the responsibility of the successor auditor performing the reaudit.

.16 *[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]*

The successor auditor should plan and perform the reaudit in accordance with generally accepted auditing standards. The successor auditor should not assume responsibility for the predecessor auditor's work or issue a report that reflects divided responsibility as described in section 543, *Part of Audit Performed by Other Independent Auditors*. Furthermore, the predecessor auditor is not a specialist as defined in AU sec. 336, *Using the Work of a Specialist*, nor does the predecessor auditor's work constitute the work of others as described in AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in*

[8] The successor auditor may wish to make inquiries about the professional reputation and standing of the predecessor auditor. See section 543, *Part of Audit Performed by Other Independent Auditors*, paragraph 10*a*.

an Audit of Financial Statements, or paragraphs 16–19 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

.17 If the successor auditor has audited the current period, the results of that audit may be considered in planning and performing the reaudit of the preceding period or periods and may provide evidential matter that is useful in performing the reaudit.

.18 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

If, in a reaudit engagement, the successor auditor is unable to obtain sufficient appropriate evidential matter to express an opinion on the financial statements, the successor auditor should qualify or disclaim an opinion because of the inability to perform procedures the successor auditor considers necessary in the circumstances.

.19 The successor auditor should request working papers for the period or periods under reaudit and the period prior to the reaudit period. However, the extent, if any, to which the predecessor auditor permits access to the working papers is a matter of judgment. (See paragraph .11 of this section.)

.20 In a reaudit, the successor auditor generally will be unable to observe inventory or make physical counts at the reaudit date or dates in the manner discussed in paragraphs .09 through .11 of section 331, *Inventories*. In such cases, the successor auditor may consider the knowledge obtained from his or her review of the predecessor auditor's working papers and inquiries of the predecessor auditor to determine the nature, timing, and extent of procedures to be applied in the circumstances. The successor auditor performing the reaudit should, if material, observe or perform some physical counts of inventory at a date subsequent to the period of the reaudit, in connection with a current audit or otherwise, and apply appropriate tests of intervening transactions. Appropriate procedures may include tests of prior transactions, reviews of records of prior counts, and the application of analytical procedures, such as gross profit tests.

Discovery of Possible Misstatements in Financial Statements Reported on by a Predecessor Auditor

.21 If during the audit or reaudit, the successor auditor becomes aware of information that leads him or her to believe that financial statements reported on by the predecessor auditor may require revision, the successor auditor should request that the client inform the predecessor auditor of the situation and arrange for the three parties to discuss this information and attempt to resolve the matter. The successor auditor should communicate to the predecessor auditor any information that the predecessor auditor may need to consider in accordance with section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, which sets out the procedures that an auditor should follow when the auditor subsequently discovers facts that may have affected the audited financial statements previously reported on.[9]

.22 If the client refuses to inform the predecessor auditor or if the successor auditor is not satisfied with the resolution of the matter, the successor auditor should evaluate (*a*) possible implications on the current engagement and

[9] See section 508, *Reports on Audited Financial Statements*, paragraphs .70 through .74, for reporting guidance.

(*b*) whether to resign from the engagement. Furthermore, the successor auditor may wish to consult with his or her legal counsel in determining an appropriate course of further action.

Effective Date

.23 This section will be effective with respect to acceptance of an engagement after March 31, 1998. Earlier application is permitted.

.24

Appendix A

Illustrative Client Consent and Acknowledgment Letter

1. Paragraph .11 of this section states, "The successor auditor should request that the client authorize the predecessor auditor to allow a review of the predecessor auditor's working papers. The predecessor auditor may wish to request a consent and acknowledgment letter from the client to document this authorization in an effort to reduce misunderstandings about the scope of the communications being authorized." The following letter is presented for illustrative purposes only and is not required by professional standards.

[*Date*]

ABC Enterprises
[*Address*]

You have given your consent to allow [*name of successor CPA firm*], as successor independent auditors for ABC Enterprises (ABC), access to our working papers for our audit of the December 31, 19X1, financial statements of ABC. You also have given your consent to us to respond fully to [*name of successor CPA firm*] inquiries. You understand and agree that the review of our working papers is undertaken solely for the purpose of obtaining an understanding about ABC and certain information about our audit to assist [*name of successor CPA firm*] in planning the audit of the December 31, 19X2, financial statements of ABC.

Please confirm your agreement with the foregoing by signing and dating a copy of this letter and returning it to us.

Attached is the form of the letter we will furnish [*name of successor CPA firm*] regarding the use of the working papers.

Very truly yours,

[*Predecessor Auditor*]

By: _____

Accepted:

ABC Enterprises

By: _____Date: _____

.25

Appendix B

Illustrative Successor Auditor Acknowledgment Letter

1. Paragraph .11, footnote 7, of this section states, "Before permitting access to the working papers, the predecessor auditor may wish to obtain a written communication from the successor auditor regarding the use of the working papers." The following letter is presented for illustrative purposes only and is not required by professional standards.

[*Date*]

[*Successor Auditor*]
[*Address*]

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the December 31, 20X1, financial statements of ABC Enterprises (ABC). We rendered a report on those financial statements and have not performed any audit procedures subsequent to the audit report date. In connection with your audit of ABC's 20X2 financial statements, you have requested access to our working papers prepared in connection with that audit. ABC has authorized our firm to allow you to review those working papers.

Our audit, and the working papers prepared in connection therewith, of ABC's financial statements were not planned or conducted in contemplation of your review. Therefore, items of possible interest to you may not have been specifically addressed. Our use of professional judgment and the assessment of audit risk and materiality for the purpose of our audit mean that matters may have existed that would have been assessed differently by you. We make no representation as to the sufficiency or appropriateness of the information in our working papers for your purposes.

We understand that the purpose of your review is to obtain information about ABC and our 19X1 audit results to assist you in planning your 19X2 audit of ABC. For that purpose only, we will provide you access to our working papers that relate to that objective.

Upon request, we will provide copies of those working papers that provide factual information about ABC. You agree to subject any such copies or information otherwise derived from our working papers to your normal policy for retention of working papers and protection of confidential client information. Furthermore, in the event of a third-party request for access to your working papers prepared in connection with your audits of ABC, you agree to obtain our permission before voluntarily allowing any such access to our working papers or information otherwise derived from our working papers, and to obtain on our behalf any releases that you obtain from such third party. You agree to advise us promptly and provide us a copy of any subpoena, summons, or other court order for access to your working papers that include copies of our working papers or information otherwise derived therefrom.

Please confirm your agreement with the foregoing by signing and dating a copy of this letter and returning it to us.

Very truly yours,

[*Predecessor Auditor*]

By: _____

Accepted:

[*Successor Auditor*]

By: _____Date: _____

Even with the client's consent, access to the predecessor auditor's working papers may still be limited. Experience has shown that the predecessor auditor may be willing to grant broader access if given additional assurance concerning the use of the working papers. Accordingly, the successor auditor might consider agreeing to the following limitations on the review of the predecessor auditor's working papers in order to obtain broader access:

- The successor auditor will not comment, orally or in writing, to anyone as a result of the review as to whether the predecessor auditor's engagement was performed in accordance with generally accepted auditing standards.
- The successor auditor will not provide expert testimony or litigation support services or otherwise accept an engagement to comment on issues relating to the quality of the predecessor auditor's audit.
- The successor auditor will not use the audit procedures or results thereof documented in the predecessor auditor's working papers as evidential matter in rendering an opinion on the 19X2 financial statements of ABC Enterprises, except as contemplated in Statement on Auditing Standards No. 84.

The following paragraph illustrates the above:

> Because your review of our working papers is undertaken solely for the purpose described above and may not entail a review of all our working papers, you agree that (1) the information obtained from the review will not be used by you for any other purpose, (2) you will not comment, orally or in writing, to anyone as a result of that review as to whether our audit was performed in accordance with generally accepted auditing standards, (3) you will not provide expert testimony or litigation support services or otherwise accept an engagement to comment on issues relating to the quality of our audit, and (4) you will not use the audit procedures or results thereof documented in our working papers as evidential matter in rendering your opinion on the 19X2 financial statements of ABC, except as contemplated in Statement on Auditing Standards No. 84.

[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

AU Section 316

Consideration of Fraud in a Financial Statement Audit

(Supersedes SAS No. 82)

Source: SAS No. 99; Auditing Standard No. 2; Auditing Standard No. 5; Auditing Standard Nos. 8–15; Auditing Standard No. 16.

Effective for audits of financial statements for periods beginning on or after December 15, 2002.

Introduction and Overview

.01 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Section 110, *Responsibilities and Functions of the Independent Auditor*, paragraph .02, states, "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. [footnote omitted]" [1] This section establishes requirements and provides direction relevant to fulfilling that responsibility, as it relates to fraud, in an audit of financial statements.[2]

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]

> Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 14–15 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, regarding fraud considerations, in addition to the fraud consideration set forth in this section.

.01A *[The following paragraph is added and effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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

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[1] The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in section 317, *Illegal Acts by Clients*. For those illegal acts that are defined in that section as having a direct and material effect on the determination of financial statement amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts is the same as that for errors, or fraud. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[2] 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. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

evaluation of audit results and determination of whether he or she has obtained sufficient appropriate audit evidence.

.02 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The following is an overview of the organization and content of this section:

- *Description and characteristics of fraud.* This section describes fraud and its characteristics. (See paragraphs .05 through .12.)
- *The importance of exercising professional skepticism.* This section discusses the need for auditors to exercise professional skepticism when considering the possibility that a material misstatement due to fraud could be present. (See paragraph .13.)
- *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).
- *Communicating about fraud to management, the audit committee, and others.* This section provides guidance regarding the auditor's communications about fraud to management, the audit committee, and others. (See paragraphs .79 through .82.)
- *Documenting the auditor's consideration of fraud.* This section describes related documentation requirements. (See paragraph .83.)

[.03] *[Paragraph deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

.04 Although this section focuses on the auditor's consideration of fraud in an audit of financial statements, it is management's responsibility to design and implement programs and controls to prevent, deter, and detect fraud.[3] That responsibility is described in section 110.03, which states, "Management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, initiate, record, process, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements." Management, along with those who have responsibility for oversight of the financial reporting process (such as the audit committee, board of trustees, board of directors, or the owner in owner-managed entities), should set the proper tone; create and maintain a culture of honesty and high ethical standards; and establish appropriate controls to prevent, deter, and detect fraud. When management and those responsible for the oversight of the financial reporting process fulfill those responsibilities, the opportunities to commit fraud can be reduced significantly.

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[3] In its October 1987 report, the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, noted, "The responsibility for reliable financial reporting resides first and foremost at the corporate level. Top management, starting with the chief executive officer, sets the tone and establishes the financial reporting environment. Therefore, reducing the risk of fraudulent financial reporting must start with the reporting company."

Description and Characteristics of Fraud

.05 Fraud is a broad legal concept and auditors do not make legal determinations of whether fraud has occurred. Rather, the auditor's interest specifically relates to acts that result in a material misstatement of the financial statements. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. For purposes of the section, *fraud* is an intentional act that results in a material misstatement in financial statements that are the subject of an audit.[4]

.06 Two types of misstatements are relevant to the auditor's consideration of fraud—misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets.

- *Misstatements arising from fraudulent financial reporting* are intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users where the effect causes the financial statements not to be presented, in all material respects, in conformity with generally accepted accounting principles (GAAP).[5] Fraudulent financial reporting may be accomplished by the following:
  - Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared
  - Misrepresentation in or intentional omission from the financial statements of events, transactions, or other significant information
  - Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure

  Fraudulent financial reporting need not be the result of a grand plan or conspiracy. It may be that management representatives rationalize the appropriateness of a material misstatement, for example, as an aggressive rather than indefensible interpretation of complex accounting rules, or as a temporary misstatement of financial statements, including interim statements, expected to be corrected later when operational results improve.
- *Misstatements arising from misappropriation of assets* (sometimes referred to as theft or defalcation) involve the theft of an entity's assets where the effect of the theft causes the financial statements not to be presented, in all material respects, in conformity with GAAP. Misappropriation of assets can be accomplished in various ways, including embezzling receipts, stealing assets, or causing an entity to pay for goods or services that have not been received.

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[4] Intent is often difficult to determine, particularly in matters involving accounting estimates and the application of accounting principles. For example, unreasonable accounting estimates may be unintentional or may be the result of an intentional attempt to misstate the financial statements. Although an audit is not designed to determine intent, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether the misstatement is intentional or not.

[5] 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. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Misappropriation of assets may be accompanied by false or misleading records or documents, possibly created by circumventing controls. The scope of this section includes only those misappropriations of assets for which the effect of the misappropriation causes the financial statements not to be fairly presented, in all material respects, in conformity with GAAP.

.07 Three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure*, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act. Some individuals possess an *attitude*, character, or set of ethical values that allow them to knowingly and intentionally commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them. The greater the incentive or pressure, the more likely an individual will be able to rationalize the acceptability of committing fraud.

.08 Management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.[6] Management can either direct employees to perpetrate fraud or solicit their help in carrying it out. In addition, management personnel at a component of the entity may be in a position to manipulate the accounting records of the component in a manner that causes a material misstatement in the consolidated financial statements of the entity. Management override of controls can occur in unpredictable ways.

.09 Typically, management and employees engaged in fraud will take steps to conceal the fraud from the auditors and others within and outside the organization. Fraud may be concealed by withholding evidence or misrepresenting information in response to inquiries or by falsifying documentation. For example, management that engages in fraudulent financial reporting might alter shipping documents. Employees or members of management who misappropriate cash might try to conceal their thefts by forging signatures or falsifying electronic approvals on disbursement authorizations. An audit conducted in accordance with GAAS rarely involves the authentication of such documentation, nor are auditors trained as or expected to be experts in such authentication. In addition, an auditor may not discover the existence of a modification of documentation through a side agreement that management or a third party has not disclosed.

.10 Fraud also may be concealed through collusion among management, employees, or third parties. Collusion may cause the auditor who has properly performed the audit to conclude that evidence provided is persuasive when it is, in fact, false. For example, through collusion, false evidence that controls have been operating effectively may be presented to the auditor, or consistent misleading explanations may be given to the auditor by more than one individual within the entity to explain an unexpected result of an analytical procedure.

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[6] Frauds have been committed by management override of existing controls using such techniques as (*a*) recording fictitious journal entries, particularly those recorded close to the end of an accounting period to manipulate operating results, (*b*) intentionally biasing assumptions and judgments used to estimate account balances, and (*c*) altering records and terms related to significant and unusual transactions.

As another example, the auditor may receive a false confirmation from a third party that is in collusion with management.

.11 Although fraud usually is concealed and management's intent is difficult to determine, the presence of certain conditions may suggest to the auditor the possibility that fraud may exist. For example, an important contract may be missing, a subsidiary ledger may not be satisfactorily reconciled to its control account, or the results of an analytical procedure performed during the audit may not be consistent with expectations. However, these conditions may be the result of circumstances other than fraud. Documents may legitimately have been lost or misfiled; the subsidiary ledger may be out of balance with its control account because of an unintentional accounting error; and unexpected analytical relationships may be the result of unanticipated changes in underlying economic factors. Even reports of alleged fraud may not always be reliable because an employee or outsider may be mistaken or may be motivated for unknown reasons to make a false allegation.

.12 As indicated in paragraph .01, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by fraud or error.[7] However, absolute assurance is not attainable and thus even a properly planned and performed audit may not detect a material misstatement resulting from fraud. A material misstatement may not be detected because of the nature of audit evidence or because the characteristics of fraud as discussed above may cause the auditor to rely unknowingly on audit evidence that appears to be valid, but is, in fact, false and fraudulent. Furthermore, audit procedures that are effective for detecting an error may be ineffective for detecting fraud.

The Importance of Exercising Professional Skepticism

.13 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Due professional care requires the auditor to exercise professional skepticism. See section 230, *Due Professional Care in the Performance of Work*, paragraphs .07 through .09. Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering fraud risks. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising professional skepticism in gathering and evaluating evidence, the auditor should not be satisfied with less-than-persuasive evidence because of a belief that management is honest.

[.14–.45][8-19] *[Paragraphs .14–.45 and preceding heading, "Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud," deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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[7] For a further discussion of the concept of reasonable assurance, see section 230, *Due Professional Care in the Performance of Work*, paragraphs .10 through .13.

[8-19] *[Footnotes 8-19 deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Responding to Assessed Fraud Risks

[.46–.50] *[Paragraphs .46–.50 deleted and preceding heading revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Overall Responses to the Risk of Material Misstatement

Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed

[.51] *[Paragraph .51 deleted and preceding heading revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

.52 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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.

.53 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The following are examples of responses to assessed fraud risks involving the nature, timing, and extent of audit procedures:

- Performing procedures at locations on a surprise or unannounced basis, for example, observing inventory on unexpected dates or at unexpected locations or counting cash on a surprise basis.
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.
- Making oral inquiries of major customers and suppliers in addition to sending written confirmations, or sending confirmation requests to a specific party within an organization.
- Performing substantive analytical procedures using disaggregated data, for example, comparing gross profit or operating margins by location, line of business, or month to auditor-developed expectations.[20]

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[20] AU sec. 329, *Substantive Analytical Procedures*, establishes requirements regarding performing analytical procedures as substantive tests. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

- 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.*)
- If other independent auditors are auditing the financial statements of one or more subsidiaries, divisions, or branches, discussing with them the extent of work that needs to be performed to address the fraud risk resulting from transactions and activities among these components.

Additional Examples of Audit Procedures Performed to Respond to Assessed Fraud Risks Relating to Fraudulent Financial Reporting

.54 *[The following paragraph and preceding heading are effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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

- *Revenue recognition.* Because revenue recognition is dependent on the particular facts and circumstances, as well as accounting principles and practices that can vary by industry, the auditor ordinarily will develop auditing procedures based on the auditor's understanding of the entity and its environment, including the composition of revenues, specific attributes of the revenue transactions, and unique industry considerations. If there is an identified fraud risk that involves improper revenue recognition, the auditor also may want to consider:
  - — Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
  - — Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements.[21] For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.
  - — Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.

[21] AU sec. 330, *The Confirmation Process*, establishes requirements regarding the confirmation process in audits of financial statements. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

— Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cutoff procedures.

— For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

- *Inventory quantities.* If there is an identified fraud risk that affects inventory quantities, examining the entity's inventory records may help identify locations or items that require specific attention during or after the physical inventory count. Such a review may lead to a decision to observe inventory counts at certain locations on an unannounced basis (see paragraph .53) or to conduct inventory counts at all locations on the same date. In addition, it may be appropriate for inventory counts to be conducted at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period.

  It also may be appropriate for the auditor to perform additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of a specialist may be helpful in this regard.[22] Furthermore, additional testing of count sheets, tags, or other records, or the retention of copies of these records, may be warranted to minimize the risk of subsequent alteration or inappropriate compilation.

  Following the physical inventory count, the auditor may want to employ additional procedures directed at the quantities included in the priced out inventories to further test the reasonableness of the quantities counted—for example, comparison of quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records. The auditor also may consider using computer-assisted audit techniques to further test the compilation of the physical inventory counts—for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication.

- *Management estimates.* The auditor may identify a fraud risk involving the development of management estimates. This risk may affect a number of accounts and assertions, including asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings, or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other postretirement benefit obligations, or environmental remediation

[22] 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. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. As indicated in section 342, *Auditing Accounting Estimates*, estimates are based on subjective as well as objective factors and there is a potential for bias in the subjective factors, even when management's estimation process involves competent personnel using relevant and reliable data.

In addressing an identified fraud risk involving accounting estimates, the auditor may want to supplement the audit evidence otherwise obtained (see section 342.09 through .14). In certain circumstances (for example, evaluating the reasonableness of management's estimate of the fair value of a derivative), it may be appropriate to engage a specialist or develop an independent estimate for comparison to management's estimate. Information gathered about the entity and its environment may help the auditor evaluate the reasonableness of such management estimates and underlying judgments and assumptions.

A retrospective review of similar management judgments and assumptions applied in prior periods (see paragraphs .63 through .65) may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

Examples of Audit Procedures Performed to Respond to Fraud Risks Relating to Misappropriations of Assets

.55 *[The following paragraph and preceding heading are effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor may have identified a fraud risk relating to misappropriation of assets. For example, the auditor may conclude that the risk of asset misappropriation at a particular operating location is significant because a large amount of easily accessible cash is maintained at that location, or there are inventory items such as laptop computers at that location that can easily be moved and sold.

.56 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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. For example, if a particular asset is highly susceptible to misappropriation and a potential misstatement would be material to the financial statements, obtaining an understanding of the controls related to the prevention and detection of such misappropriation and testing the design and operating effectiveness of such controls may be warranted. In certain circumstances, physical inspection of such assets (for example, counting cash or securities) at or near the end of the reporting period may be appropriate. In addition, the use of substantive analytical procedures, such as the development by the auditor of an expected dollar amount at a high level of precision, to be compared with a recorded amount, may be effective in certain circumstances.

Audit Procedures Performed to Specifically Address the Risk of Management Override of Controls

.57 *[The following paragraph and preceding heading are effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

As noted in paragraph .08, management is in a unique position to perpetrate fraud because of its ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding established controls that otherwise appear to be operating effectively. By its nature, management override of controls can occur in unpredictable ways. 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.

.58 ***Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.*** Material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process by (*a*) recording inappropriate or unauthorized journal entries throughout the year or at period end, or (*b*) making adjustments to amounts reported in the financial statements that are not reflected in formal journal entries, such as through consolidating adjustments, report combinations, and reclassifications. Accordingly, the auditor should design procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments (for example, entries posted directly to financial statement drafts) made in the preparation of the financial statements. More specifically, the auditor should:

a. Obtain an understanding of the entity's financial reporting process[23] and the controls over journal entries and other adjustments. (See paragraphs .59 and .60.)

b. Identify and select journal entries and other adjustments for testing. (See paragraph .61.)

c. Determine the timing of the testing. (See paragraph .62.)

d. Inquire of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.

.59 The auditor's understanding of the entity's financial reporting process may help in identifying the type, number, and monetary value of journal entries and other adjustments that typically are made in preparing the financial statements. For example, the auditor's understanding may include the sources of significant debits and credits to an account, who can initiate entries to the general ledger or transaction processing systems, what approvals are required for such entries, and how journal entries are recorded (for example, entries may be initiated and recorded online with no physical evidence, or may be created in paper form and entered in batch mode).

.60 An entity may have implemented specific controls over journal entries and other adjustments. For example, an entity may use journal entries that are preformatted with account numbers and specific user approval criteria, and may have automated controls to generate an exception report for any entries that were unsuccessfully proposed for recording or entries that were recorded

[23] See paragraphs 28 through 32 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

and processed outside of established parameters. The auditor should obtain an understanding of the design of such controls over journal entries and other adjustments and determine whether they are suitably designed and have been placed in operation.

.61 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor should use professional judgment in determining the nature, timing, and extent of the testing of journal entries and other adjustments. For purposes of identifying and selecting specific entries and other adjustments for testing, and determining the appropriate method of examining the underlying support for the items selected, the auditor should consider:

- *The auditor's assessment of fraud risk due to fraud.* The presence of fraud risk factors or other conditions may help the auditor to identify specific classes of journal entries for testing and indicate the extent of testing necessary.
- *The effectiveness of controls that have been implemented over journal entries and other adjustments.* 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.
- *The entity's financial reporting process and the nature of the evidence that can be examined.* The auditor's procedures for testing journal entries and other adjustments will vary based on the nature of the financial reporting process. For many entities, routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments might involve both manual and automated procedures and controls. Regardless of the method, the auditor's procedures should include selecting from the general ledger journal entries to be tested and examining support for those items. In addition, the auditor should be aware that journal entries and other adjustments might exist in either electronic or paper form. When information technology (IT) is used in the financial reporting process, journal entries and other adjustments might exist only in electronic form. Electronic evidence often requires extraction of the desired data by an auditor with IT knowledge and skills or the use of an IT specialist. In an IT environment, it may be necessary for the auditor to employ computer-assisted audit techniques (for example, report writers, software or data extraction tools, or other systems-based techniques) to identify the journal entries and other adjustments to be tested.
- *The characteristics of fraudulent entries or adjustments.* Inappropriate journal entries and other adjustments often have certain unique identifying characteristics. Such characteristics may include entries (*a*) made to unrelated, unusual, or seldom-used accounts, (*b*) made by individuals who typically do not make journal entries, (*c*) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (*d*) made either before or during the preparation of the financial statements

that do not have account numbers, or (*e*) containing round numbers or a consistent ending number.

- *The nature and complexity of the accounts.* Inappropriate journal entries or adjustments may be applied to accounts that (*a*) contain transactions that are complex or unusual in nature, (*b*) contain significant estimates and period-end adjustments, (*c*) have been prone to errors in the past, (*d*) have not been reconciled on a timely basis or contain unreconciled differences, (*e*) contain intercompany transactions, or (*f*) are otherwise associated with an identified fraud risk. The auditor should recognize, however, that inappropriate journal entries and adjustments also might be made to other accounts. 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*.
- *Journal entries or other adjustments processed outside the normal course of business.* Standard journal entries used on a recurring basis to record transactions such as monthly sales, purchases, and cash disbursements, or to record recurring periodic accounting estimates generally are subject to the entity's internal controls. Nonstandard entries (for example, entries used to record nonrecurring transactions, such as a business combination, or entries used to record a nonrecurring estimate, such as an asset impairment) might not be subject to the same level of internal control. In addition, other adjustments such as consolidating adjustments, report combinations, and reclassifications generally are not reflected in formal journal entries and might not be subject to the entity's internal controls. Accordingly, the auditor should consider placing additional emphasis on identifying and testing items processed outside of the normal course of business.

.62 Because fraudulent journal entries often are made at the end of a reporting period, the auditor's testing ordinarily should focus on the journal entries and other adjustments made at that time. However, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how it is accomplished, the auditor should consider whether there also is a need to test journal entries throughout the period under audit.

.63 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Reviewing accounting estimates for biases that could result in material misstatement due to fraud. In preparing financial statements, management is responsible for making a number of judgments or assumptions that affect significant accounting estimates[24] and for monitoring the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting often is accomplished through intentional misstatement of accounting estimates. 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.

.64 The auditor also should perform a retrospective review of significant accounting estimates reflected in the financial statements of the prior year to

[24] See section 342, *Auditing Accounting Estimates*, paragraphs .02 and .16, for a definition of accounting estimates and a listing of examples.

determine whether management judgments and assumptions relating to the estimates indicate a possible bias on the part of management. The significant accounting estimates selected for testing should include those that are based on highly sensitive assumptions or are otherwise significantly affected by judgments made by management. With the benefit of hindsight, a retrospective review should provide the auditor with additional information about whether there may be a possible bias on the part of management in making the current-year estimates. This review, however, is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.

.65 If the auditor identifies a possible bias on the part of management in making accounting estimates, the auditor should evaluate whether circumstances producing such a bias represent a risk of a material misstatement due to fraud. For example, information coming to the auditor's attention may indicate a risk that adjustments to the current-year estimates might be recorded at the instruction of management to arbitrarily achieve a specified earnings target.

.66 ***Evaluating the business rationale for significant unusual transactions.*** During the course of the audit, the auditor may become aware of significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment. The auditor should gain an understanding of the business rationale for such transactions and whether that rationale (or the lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

.67 In understanding the business rationale for the transactions, the auditor should consider:

- Whether the form of such transactions is overly complex (for example, involves multiple entities within a consolidated group or unrelated third parties).
- Whether management has discussed the nature of and accounting for such transactions with the audit committee or board of directors.
- Whether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Whether transactions that involve unconsolidated related parties, including special purpose entities, have been properly reviewed and approved by the audit committee or board of directors.
- Whether the transactions involve previously unidentified related parties[25] or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

[.68–.78] [26–36] *[Paragraphs .68–.78 and preceding heading, "Evaluating Audit Evidence," deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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[25] Section 334, *Related Parties*, provides guidance with respect to the identification of related-party relationships and transactions, including transactions that may be outside the ordinary course of business (see, in particular, section 334.06).

[26–36] *[Footnotes 26–36 deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Communicating About Possible Fraud to Management, the Audit Committee, and Others[37]

.79 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the entity's organization. Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to the audit committee in a timely manner and prior to the issuance of the auditor's report. In addition, the auditor should reach an understanding with the audit committee regarding the nature and extent of communications with the committee about misappropriations perpetrated by lower-level employees.

.80 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

If the auditor, as a result of the assessment of the risks of material misstatement, has identified fraud risks that have continuing control implications (whether or not transactions or adjustments that could be the result of fraud have been detected), the auditor should consider whether these risks represent significant deficiencies that must be communicated to senior management and the audit committee.[38] (See section 325, "Communications About Control Deficiencies in An Audit of Financial Statements," paragraph 4.). 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.

.81 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]

The auditor also should consider communicating other fraud risks, if any, identified by the auditor. Such a communication may be a part of an overall communication to the audit committee of business and financial statement risks affecting the entity and/or in conjunction with the auditor communication about the qualitative aspects of the entity's accounting policies and practices (see paragraphs 12–13 of Auditing Standard No. 16, *Communications with Audit Committees*). The auditor should communicate these matters to the audit committee in a timely manner and prior to the issuance of the auditor's report.

.82 The disclosure of possible fraud to parties other than the client's senior management and its audit committee ordinarily is not part of the auditor's responsibility and ordinarily would be precluded by the auditor's ethical or legal

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[37] The requirements to communicate noted in paragraphs .79 through .82 extend to any intentional misstatement of financial statements (see paragraph .03). However, the communication may use terms other than fraud—for example, irregularity, intentional misstatement, misappropriation, or defalcations—if there is possible confusion with a legal definition of fraud or other reason to prefer alternative terms.

[38] Alternatively, the auditor may decide to communicate solely with the audit committee.

obligations of confidentiality unless the matter is reflected in the auditor's report. The auditor should recognize, however, that in the following circumstances a duty to disclose to parties outside the entity may exist:

a. To comply with certain legal and regulatory requirements[39]

b. To a successor auditor when the successor makes inquiries in accordance with section 315, *Communications Between Predecessor and Successor Auditors*[40]

c. In response to a subpoena

d. To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive governmental financial assistance[41]

Because potential conflicts between the auditor's ethical and legal obligations for confidentiality of client matters may be complex, the auditor may wish to consult with legal counsel before discussing matters covered by paragraphs .79 through .81 with parties outside the client.

Documenting the Auditor's Consideration of Fraud

.83 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor should document the following:

- The discussion among engagement personnel in planning the audit regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, including how and when the discussion occurred, the audit team members who participated, and the subject matter discussed (See paragraphs 52 and 53 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.)
- The procedures performed to obtain information necessary to identify and assess the fraud risks (See paragraph 47, paragraphs 56 through 58, and paragraphs 65 through 69 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.)
- 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*).
- If the auditor has not identified in a particular circumstance, improper revenue recognition as a fraud risk, the reasons supporting the auditor's conclusion (See paragraph 68 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.)

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[39] These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change on Form 8-K and the fraud or related risk factors constitute a *reportable event* or is the source of a *disagreement*, as these terms are defined in Item 304 of Regulation S-K. These requirements also include reports that may be required, under certain circumstances, pursuant to Section 10A(b)1 of the Securities Exchange Act of 1934 relating to an illegal act that has a material effect on the financial statements.

[40] Section 315 requires the specific permission of the client.

[41] For example, *Government Auditing Standards* (the Yellow Book) require auditors to report fraud or illegal acts directly to parties outside the audited entity in certain circumstances.

- 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*.)
- Other conditions and analytical relationships that caused the auditor to believe that additional auditing procedures or other responses were required and any further responses the auditor concluded were appropriate, to address such risks or other conditions (See paragraphs 5 through 9 of Auditing Standard No. 14, *Evaluating Audit Results*.)
- The nature of the communications about fraud made to management, the audit committee, and others (See paragraphs .79 through .82.)

[.84] *[Paragraph .84 and preceding heading, "Effective Date," deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

.85

Appendix

Examples of Fraud Risk Factors

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]

A.1 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*. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration—that is, fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (*a*) incentives/pressures, (*b*) opportunities, and (*c*) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting

A.2 The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

Incentives/Pressures

a. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- — High degree of competition or market saturation, accompanied by declining margins
- — High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
- — Significant declines in customer demand and increasing business failures in either the industry or overall economy
- — Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent
- — Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth
- — Rapid growth or unusual profitability, especially compared to that of other companies in the same industry
- — New accounting, statutory, or regulatory requirements

b. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

— Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages

— Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures

— Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements

— Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards

c. Information available indicates that management or the board of directors' personal financial situation is threatened by the entity's financial performance arising from the following:

— Significant financial interests in the entity

— Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow[1]

— Personal guarantees of debts of the entity

d. There is excessive pressure on management or operating personnel to meet financial targets set up by the board of directors or management, including sales or profitability incentive goals.

Opportunities

a. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

— Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm

— A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions

— Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate

— Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions

[1] Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.

— Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist

— Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification

b. There is ineffective monitoring of management as a result of the following:

— Domination of management by a single person or small group (in a nonowner-managed business) without compensating controls

— Ineffective board of directors or audit committee oversight over the financial reporting process and internal control

c. There is a complex or unstable organizational structure, as evidenced by the following:

— Difficulty in determining the organization or individuals that have controlling interest in the entity

— Overly complex organizational structure involving unusual legal entities or managerial lines of authority

— High turnover of senior management, counsel, or board members

d. Internal control components are deficient as a result of the following:

— Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required)

— High turnover rates or employment of ineffective accounting, internal audit, or information technology staff

— Ineffective accounting and information systems, including situations involving reportable conditions

Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by board members, management, or employees, that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

- Ineffective communication, implementation, support, or enforcement of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards
- Nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or board members alleging fraud or violations of laws and regulations

- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend
- A practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts
- Management failing to correct known reportable conditions on a timely basis
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
  - — Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters
  - — Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report
  - — Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or audit committee
  - — Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement

Risk Factors Relating to Misstatements Arising From Misappropriation of Assets

A.3 Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalizations. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weaknesses in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives/Pressures

a. Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

b. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

— Known or anticipated future employee layoffs

— Recent or anticipated changes to employee compensation or benefit plans

— Promotions, compensation, or other rewards inconsistent with expectations

Opportunities

a. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

— Large amounts of cash on hand or processed

— Inventory items that are small in size, of high value, or in high demand

— Easily convertible assets, such as bearer bonds, diamonds, or computer chips

— Fixed assets that are small in size, marketable, or lacking observable identification of ownership

b. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

— Inadequate segregation of duties or independent checks

— Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations

— Inadequate job applicant screening of employees with access to assets

— Inadequate recordkeeping with respect to assets

— Inadequate system of authorization and approval of transactions (for example, in purchasing)

— Inadequate physical safeguards over cash, investments, inventory, or fixed assets

— Lack of complete and timely reconciliations of assets

— Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns

— Lack of mandatory vacations for employees performing key control functions

— Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation

— Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations

Risk factors reflective of employee attitudes/rationalizations that allow them to justify misappropriations of assets, are generally not susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence

of such information should consider it in identifying the risks of material misstatement arising from misappropriation of assets. For example, auditors may become aware of the following attitudes or behavior of employees who have access to assets susceptible to misappropriation:

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies
- Behavior indicating displeasure or dissatisfaction with the company or its treatment of the employee
- Changes in behavior or lifestyle that may indicate assets have been misappropriated

.86

Amendment to Section 230, *Due Professional Care in the Performance of Work*

1. This section amends section 230, *Due Professional Care in the Performance of Work*, paragraphs .12 and .13, to include a discussion about the characteristics of fraud and a discussion about collusion. (The new language is shown in boldface italics; deleted language is shown by strikethrough.)

Reasonable Assurance

.10 The exercise of due professional care allows the auditor to obtain *reasonable assurance* that the financial statements are free of material misstatement, whether caused by error or fraud. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, an audit conducted in accordance with generally accepted auditing standards may not detect a material misstatement.

.11 The independent auditor's objective is to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming an opinion. The nature of most evidence derives, in part, from the concept of selective testing of the data being audited, which involves judgment regarding both the areas to be tested and the nature, timing, and extent of the tests to be performed. In addition, judgment is required in interpreting the results of audit testing and evaluating audit evidence. Even with good faith and integrity, mistakes and errors in judgment can be made. Furthermore, accounting presentations contain accounting estimates, the measurement of which is inherently uncertain and depends on the outcome of future events. The auditor exercises professional judgment in evaluating the reasonableness of accounting estimates based on information that could reasonably be expected to be available prior to the completion of field work.[5] As a result of these factors, in the great majority of cases, the auditor has to rely on evidence that is persuasive rather than convincing.[6]

.12 Because of the characteristics of fraud, ~~particularly those involving concealment and falsified documentation (including forgery),~~ a properly planned and performed audit may not detect a material misstatement. ***Characteristics of fraud include (a) concealment through collusion among management, employees, or third parties; (b) withheld, misrepresented, or falsified documentation; and (c) the ability of management to override or instruct others to override what otherwise appears to be effective controls.*** For example, ~~an audit conducted in accordance with generally accepted auditing standards rarely involves authentication of documentation, nor are auditors trained as or expected to be experts in such authentication. Also,~~ auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion among ~~client~~ personnel ***within the entity*** and third parties or among management or employees of the ~~client~~ ***entity. Collusion may cause the auditor who has properly performed the audit to conclude that evidence provided is persuasive when it is, in fact, false. In addition, an audit conducted in accordance with generally accepted auditing standards rarely involves authentication of documentation, nor are auditors trained as or expected to be experts in such authentication. Furthermore, an auditor may not discover the existence of a modification of documentation through a side agreement that management or a third party has not disclosed. Finally, management has***

[5] See section 342, *Auditing Accounting Estimates*.

[6] See section 326, *Evidential Matter*.

the ability to directly or indirectly manipulate accounting records and present fraudulent financial information by overriding controls in unpredictable ways.

.13 Since the auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement, whether from error or fraud, exists in the financial statements does not, in and of itself, evidence (*a*) failure to obtain reasonable assurance, (*b*) inadequate planning, performance, or judgment, (*c*) the absence of due professional care, or (*d*) a failure to comply with generally accepted auditing standards.

.87

Amendment to Section 333, *Management Representations*, paragraph .06 and Appendix A [paragraph .16]

1. This section requires the auditor to make inquiries of management about fraud and the risk of fraud. In support of and consistent with these inquiries, this amendment revises the guidance for management representations about fraud currently found in section 333, *Management Representations*, paragraph .06*h*, and Appendix A [paragraph .16]). New language is shown in boldface italics; deleted language is shown by strikethrough.

h. Management's acknowledgment of its responsibility for the design and implementation of programs and controls to prevent and detect fraud

~~*i*~~h. ***Knowledge of*** fraud ***or suspected fraud affecting the entity*** involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements[8]

j. Knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others

2. Subsequent subparagraphs and footnotes are to be renumbered accordingly.

Appendix A

Illustrative Management Representation Letter

2. If matters exist that should be disclosed to the auditor, they should be indicated by ~~listing them following~~***modifying*** the ***related*** representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, the final paragraph could be modified as follows: "To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred. . . ." ~~Similarly, i~~***I***n appropriate circumstances, item ***9***~~7~~ could be modified as follows: "The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except for ***its***~~our~~ plans to dispose of segment A, as disclosed in ~~footn.~~***N***ote X to the financial statements, which are discussed in the minutes of the December 7, ***20***~~19~~X1, meeting of the board of directors." ***Similarly, if management has received a communication regarding an allegation of fraud or suspected fraud, item 8 could be modified as follows: "Except for the allegation discussed in the minutes of the December 7, 20X1, meeting of the board of directors (or disclosed to you at our meeting on October 15, 20X1), we have no knowledge of any allegations of fraud or suspected fraud affecting the company received in communications from employees, former employees, analysts, regulators, short sellers, or others."***

3. The qualitative discussion of materiality used in the illustrative letter is adapted from FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*.

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[8] ~~See section 316.~~

4. Certain terms are used in the illustrative letter that are described elsewhere in authoritative literature. Examples are fraud, in section 316, and related parties, in section 334, footnote 1. To avoid misunderstanding concerning the meaning of such terms, the auditor may wish to furnish those definitions to management or request that the definitions be included in the written representations.

5. The illustrative letter assumes that management and the auditor have reached an understanding on the limits of materiality for purposes of the written representations. However, it should be noted that a materiality limit would not apply for certain representations, as explained in paragraph .08 of this section.

6.

[*Date*]

To [*Independent Auditor*]

We are providing this letter in connection with your audit(s) of the [*identification of financial statements*] of [*name of entity*] as of [*dates*] and for the [*periods*] for the purpose of expressing an opinion as to whether the [*consolidated*] financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of [*name of entity*] in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the [*consolidated*] financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, [*as of (date of auditor's report)*,] the following representations made to you during your audit(s).

1. The financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America.
2. We have made available to you all—
   a. Financial records and related data.
   b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
5. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.[fn 1]
[Footnote omitted]

6. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.

7. ~~6.~~ ***We have no knowledge of any fraud or suspected fraud affecting the entity involving*** ~~There has been no~~ —

a. ***Management,*** ~~Fraud involving management, or employees who have significant roles in the internal control~~

b. ***Employees who have significant roles in internal control, or***

c. ~~Fraud involving o~~***O***thers where the fraud could have a material effect on the financial statements.

8. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.

3. Subsequent subparagraphs are to be renumbered accordingly.

Exhibit—Management Antifraud Programs and Controls

Guidance to Help Prevent, Deter, and Detect Fraud

.88

(This exhibit is reprinted for the reader's convenience but is not an integral part of the section.)

This document is being issued jointly by the following organizations:

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Preface

Some organizations have significantly lower levels of misappropriation of assets and are less susceptible to fraudulent financial reporting than other organizations because these organizations take proactive steps to prevent or deter

fraud. It is only those organizations that seriously consider fraud risks and take proactive steps to create the right kind of climate to reduce its occurrence that have success in preventing fraud. This document identifies the key participants in this antifraud effort, including the board of directors, management, internal and independent auditors, and certified fraud examiners.

Management may develop and implement some of these programs and controls in response to specific identified risks of material misstatement of financial statements due to fraud. In other cases, these programs and controls may be a part of the entity's enterprise-wide risk management activities.

Management is responsible for designing and implementing systems and procedures for the prevention and detection of fraud and, along with the board of directors, for ensuring a culture and environment that promotes honesty and ethical behavior. However, because of the characteristics of fraud, a material misstatement of financial statements due to fraud may occur notwithstanding the presence of programs and controls such as those described in this document.

Introduction

Fraud can range from minor employee theft and unproductive behavior to misappropriation of assets and fraudulent financial reporting. Material financial statement fraud can have a significant adverse effect on an entity's market value, reputation, and ability to achieve its strategic objectives. A number of highly publicized cases have heightened the awareness of the effects of fraudulent financial reporting and have led many organizations to be more proactive in taking steps to prevent or deter its occurrence. Misappropriation of assets, though often not material to the financial statements, can nonetheless result in substantial losses to an entity if a dishonest employee has the incentive and opportunity to commit fraud.

The risk of fraud can be reduced through a combination of prevention, deterrence, and detection measures. However, fraud can be difficult to detect because it often involves concealment through falsification of documents or collusion among management, employees, or third parties. Therefore, it is important to place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals that they should not commit fraud because of the likelihood of detection and punishment. Moreover, prevention and deterrence measures are much less costly than the time and expense required for fraud detection and investigation.

An entity's management has both the responsibility and the means to implement measures to reduce the incidence of fraud. The measures an organization takes to prevent and deter fraud also can help create a positive workplace environment that can enhance the entity's ability to recruit and retain high-quality employees.

Research suggests that the most effective way to implement measures to reduce wrongdoing is to base them on a set of core values that are embraced by the entity. These values provide an overarching message about the key principles guiding all employees' actions. This provides a platform upon which a more detailed code of conduct can be constructed, giving more specific guidance about permitted and prohibited behavior, based on applicable laws and the organization's values. Management needs to clearly articulate that all employees will be held accountable to act within the organization's code of conduct.

This document identifies measures entities can implement to prevent, deter, and detect fraud. It discusses these measures in the context of three fundamental elements. Broadly stated, these fundamental elements are (1) create and maintain a *culture* of honesty and high ethics; (2) *evaluate* the risks of fraud and implement the processes, procedures, and controls needed to mitigate the risks and reduce the opportunities for fraud; and (3) develop an appropriate *oversight* process. Although the entire management team shares the responsibility for implementing and monitoring these activities, with oversight from the board of directors, the entity's chief executive officer (CEO) should initiate and support such measures. Without the CEO's active support, these measures are less likely to be effective.

The information presented in this document generally is applicable to entities of all sizes. However, the degree to which certain programs and controls are applied in smaller, less-complex entities and the formality of their application are likely to differ from larger organizations. For example, management of a smaller entity (or the owner of an owner-managed entity), along with those charged with governance of the financial reporting process, are responsible for creating a culture of honesty and high ethics. Management also is responsible for implementing a system of internal controls commensurate with the nature and size of the organization, but smaller entities may find that certain types of control activities are not relevant because of the involvement of and controls applied by management. However, all entities must make it clear that unethical or dishonest behavior will not be tolerated.

Creating a Culture of Honesty and High Ethics

It is the organization's responsibility to create a culture of honesty and high ethics and to clearly communicate acceptable behavior and expectations of each employee. Such a culture is rooted in a strong set of core values (or value system) that provides the foundation for employees as to how the organization conducts its business. It also allows an entity to develop an ethical framework that covers (1) fraudulent financial reporting, (2) misappropriation of assets, and (3) corruption as well as other issues.[1]

Creating a culture of honesty and high ethics should include the following.

Setting the Tone at the Top

Directors and officers of corporations set the "tone at the top" for ethical behavior within any organization. Research in moral development strongly suggests that honesty can best be reinforced when a proper example is set—sometimes referred to as the tone at the top. The management of an entity cannot act one way and expect others in the entity to behave differently.

In many cases, particularly in larger organizations, it is necessary for management to both behave ethically and openly communicate its expectations for ethical behavior because most employees are not in a position to observe management's actions. Management must show employees through its words and actions that dishonest or unethical behavior will not be tolerated, even if the result of the action benefits the entity. Moreover, it should be evident that all employees will be treated equally, regardless of their position.

For example, statements by management regarding the absolute need to meet operating and financial targets can create undue pressures that may lead

[1] Corruption includes bribery and other illegal acts.

employees to commit fraud to achieve them. Setting unachievable goals for employees can give them two unattractive choices: fail or cheat. In contrast, a statement from management that says, "We are aggressive in pursuing our targets, while requiring truthful financial reporting at all times," clearly indicates to employees that integrity is a requirement. This message also conveys that the entity has "zero tolerance" for unethical behavior, including fraudulent financial reporting.

The cornerstone of an effective antifraud environment is a culture with a strong value system founded on integrity. This value system often is reflected in a code of conduct.[2] The code of conduct should reflect the core values of the entity and guide employees in making appropriate decisions during their workday. The code of conduct might include such topics as ethics, confidentiality, conflicts of interest, intellectual property, sexual harassment, and fraud.[3] For a code of conduct to be effective, it should be communicated to all personnel in an understandable fashion. It also should be developed in a participatory and positive manner that will result in both management and employees taking ownership of its content. Finally, the code of conduct should be included in an employee handbook or policy manual, or in some other formal document or location (for example, the entity's intranet) so it can be referred to when needed.

Senior financial officers hold an important and elevated role in corporate governance. While members of the management team, they are uniquely capable and empowered to ensure that all stakeholders' interests are appropriately balanced, protected, and preserved. For examples of codes of conduct, see Attachment 1, "AICPA 'CPA's Handbook of Fraud and Commercial Crime Prevention,' An Organizational Code of Conduct," and Attachment 2, "Financial Executives International Code of Ethics Statement" provided by Financial Executives International. In addition, visit the Institute of Management Accountant's Ethics Center at www.imanet.org for their members' standards of ethical conduct.

Creating a Positive Workplace Environment

Research results indicate that wrongdoing occurs less frequently when employees have positive feelings about an entity than when they feel abused, threatened, or ignored. Without a positive workplace environment, there are more opportunities for poor employee morale, which can affect an employee's attitude about committing fraud against an entity. Factors that detract from a positive work environment and may increase the risk of fraud include:

- Top management that does not seem to care about or reward appropriate behavior
- Negative feedback and lack of recognition for job performance
- Perceived inequities in the organization
- Autocratic rather than participative management
- Low organizational loyalty or feelings of ownership
- Unreasonable budget expectations or other financial targets

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[2] An entity's value system also could be reflected in an ethics policy, a statement of business principles, or some other concise summary of guiding principles.

[3] Although the discussion in this document focuses on fraud, the subject of fraud often is considered in the context of a broader set of principles that govern an organization. Some organizations, however, may elect to develop a fraud policy separate from an ethics policy. Specific examples of topics in a fraud policy might include a requirement to comply with all laws and regulations and explicit guidance regarding making payments to obtain contracts, holding pricing discussions with competitors, environmental discharges, relationships with vendors, and maintenance of accurate books and records.

- Fear of delivering "bad news" to supervisors and/or management
- Less-than-competitive compensation
- Poor training and promotion opportunities
- Lack of clear organizational responsibilities
- Poor communication practices or methods within the organization

The entity's human resources department often is instrumental in helping to build a corporate culture and a positive work environment. Human resource professionals are responsible for implementing specific programs and initiatives, consistent with management's strategies, that can help to mitigate many of the detractors mentioned above. Mitigating factors that help create a positive work environment and reduce the risk of fraud may include:

- Recognition and reward systems that are in tandem with goals and results
- Equal employment opportunities
- Team-oriented, collaborative decision-making policies
- Professionally administered compensation programs
- Professionally administered training programs and an organizational priority of career development

Employees should be empowered to help create a positive workplace environment and support the entity's values and code of conduct. They should be given the opportunity to provide input to the development and updating of the entity's code of conduct, to ensure that it is relevant, clear, and fair. Involving employees in this fashion also may effectively contribute to the oversight of the entity's code of conduct and an environment of ethical behavior (see the section titled "Developing an Appropriate Oversight Process").

Employees should be given the means to obtain advice internally before making decisions that appear to have significant legal or ethical implications. They should also be encouraged and given the means to communicate concerns, anonymously if preferred, about potential violations of the entity's code of conduct, without fear of retribution. Many organizations have implemented a process for employees to report on a confidential basis any actual or suspected wrongdoing, or potential violations of the code of conduct or ethics policy. For example, some organizations use a telephone "hotline" that is directed to or monitored by an ethics officer, fraud officer, general counsel, internal audit director, or another trusted individual responsible for investigating and reporting incidents of fraud or illegal acts.

Hiring and Promoting Appropriate Employees

Each employee has a unique set of values and personal code of ethics. When faced with sufficient pressure and a perceived opportunity, some employees will behave dishonestly rather than face the negative consequences of honest behavior. The threshold at which dishonest behavior starts, however, will vary among individuals. If an entity is to be successful in preventing fraud, it must have effective policies that minimize the chance of hiring or promoting individuals with low levels of honesty, especially for positions of trust.

Proactive hiring and promotion procedures may include:

- Conducting background investigations on individuals being considered for employment or for promotion to a position of trust[4]
- Thoroughly checking a candidate's education, employment history, and personal references
- Periodic training of all employees about the entity's values and code of conduct, (training is addressed in the following section)
- Incorporating into regular performance reviews an evaluation of how each individual has contributed to creating an appropriate workplace environment in line with the entity's values and code of conduct
- Continuous objective evaluation of compliance with the entity's values and code of conduct, with violations being addressed immediately

Training

New employees should be trained at the time of hiring about the entity's values and its code of conduct. This training should explicitly cover expectations of all employees regarding (1) their duty to communicate certain matters; (2) a list of the types of matters, including actual or suspected fraud, to be communicated along with specific examples; and (3) information on how to communicate those matters. There also should be an affirmation from senior management regarding employee expectations and communication responsibilities. Such training should include an element of "fraud awareness," the tone of which should be positive but nonetheless stress that fraud can be costly (and detrimental in other ways) to the entity and its employees.

In addition to training at the time of hiring, employees should receive refresher training periodically thereafter. Some organizations may consider ongoing training for certain positions, such as purchasing agents or employees with financial reporting responsibilities. Training should be specific to an employee's level within the organization, geographic location, and assigned responsibilities. For example, training for senior manager level personnel would normally be different from that of nonsupervisory employees, and training for purchasing agents would be different from that of sales representatives.

Confirmation

Management needs to clearly articulate that all employees will be held accountable to act within the entity's code of conduct. All employees within senior management and the finance function, as well as other employees in areas that might be exposed to unethical behavior (for example, procurement, sales and marketing) should be required to sign a code of conduct statement annually, at a minimum.

Requiring periodic confirmation by employees of their responsibilities will not only reinforce the policy but may also deter individuals from committing fraud and other violations and might identify problems before they become significant. Such confirmation may include statements that the individual understands the entity's expectations, has complied with the code of conduct, and is not aware of any violations of the code of conduct other than those the individual lists in his or her response. Although people with low integrity may not hesitate to sign a false confirmation, most people will want to avoid making a false statement in writing. Honest individuals are more likely to return

[4] Some organizations also have considered follow-up investigations, particularly for employees in positions of trust, on a periodic basis (for example, every five years) or as circumstances dictate.

their confirmations and to disclose what they know (including any conflicts of interest or other personal exceptions to the code of conduct). Thorough follow-up by internal auditors or others regarding nonreplies may uncover significant issues.

Discipline

The way an entity reacts to incidents of alleged or suspected fraud will send a strong deterrent message throughout the entity, helping to reduce the number of future occurrences. The following actions should be taken in response to an alleged incident of fraud:

- A thorough investigation of the incident should be conducted.[5]
- Appropriate and consistent actions should be taken against violators.
- Relevant controls should be assessed and improved.
- Communication and training should occur to reinforce the entity's values, code of conduct, and expectations.

Expectations about the consequences of committing fraud must be clearly communicated throughout the entity. For example, a strong statement from management that dishonest actions will not be tolerated, and that violators may be terminated and referred to the appropriate authorities, clearly establishes consequences and can be a valuable deterrent to wrongdoing. If wrongdoing occurs and an employee is disciplined, it can be helpful to communicate that fact, on a no-name basis, in an employee newsletter or other regular communication to employees. Seeing that other people have been disciplined for wrongdoing can be an effective deterrent, increasing the perceived likelihood of violators being caught and punished. It also can demonstrate that the entity is committed to an environment of high ethical standards and integrity.

Evaluating Antifraud Processes and Controls

Neither fraudulent financial reporting nor misappropriation of assets can occur without a perceived opportunity to commit and conceal the act. Organizations should be proactive in reducing fraud opportunities by (1) identifying and measuring fraud risks, (2) taking steps to mitigate identified risks, and (3) implementing and monitoring appropriate preventive and detective internal controls and other deterrent measures.

Identifying and Measuring Fraud Risks

Management has primary responsibility for establishing and monitoring all aspects of the entity's fraud risk-assessment and prevention activities.[6] Fraud risks often are considered as part of an enterprise-wide risk management

[5] Many entities of sufficient size are employing antifraud professionals, such as certified fraud examiners, who are responsible for resolving allegations of fraud within the organization and who also assist in the detection and deterrence of fraud. These individuals typically report their findings internally to the corporate security, legal, or internal audit departments. In other instances, such individuals may be empowered directly by the board of directors or its audit committee.

[6] Management may elect to have internal audit play an active role in the development, monitoring, and ongoing assessment of the entity's fraud risk-management program. This may include an active role in the development and communication of the entity's code of conduct or ethics policy, as well as in investigating actual or alleged instances of noncompliance.

program, though they may be addressed separately.[7] The fraud risk-assessment process should consider the vulnerability of the entity to fraudulent activity (fraudulent financial reporting, misappropriation of assets, and corruption) and whether any of those exposures could result in a material misstatement of the financial statements or material loss to the organization. In identifying fraud risks, organizations should consider organizational, industry, and country-specific characteristics that influence the risk of fraud.

The nature and extent of management's risk assessment activities should be commensurate with the size of the entity and complexity of its operations. For example, the risk assessment process is likely to be less formal and less structured in smaller entities. However, management should recognize that fraud can occur in organizations of any size or type, and that almost any employee may be capable of committing fraud given the right set of circumstances. Accordingly, management should develop a heightened "fraud awareness" and an appropriate fraud risk-management program, with oversight from the board of directors or audit committee.

Mitigating Fraud Risks

It may be possible to reduce or eliminate certain fraud risks by making changes to the entity's activities and processes. An entity may choose to sell certain segments of its operations, cease doing business in certain locations, or reorganize its business processes to eliminate unacceptable risks. For example, the risk of misappropriation of funds may be reduced by implementing a central lockbox at a bank to receive payments instead of receiving money at the entity's various locations. The risk of corruption may be reduced by closely monitoring the entity's procurement process. The risk of financial statement fraud may be reduced by implementing shared services centers to provide accounting services to multiple segments, affiliates, or geographic locations of an entity's operations. A shared services center may be less vulnerable to influence by local operations managers and may be able to implement more extensive fraud detection measures cost-effectively.

Implementing and Monitoring Appropriate Internal Controls

Some risks are inherent in the environment of the entity, but most can be addressed with an appropriate system of internal control. Once fraud risk assessment has taken place, the entity can identify the processes, controls, and other procedures that are needed to mitigate the identified risks. Effective internal control will include a well-developed control environment, an effective and secure information system, and appropriate control and monitoring activities.[8] Because of the importance of information technology in supporting operations and the processing of transactions, management also needs to implement and maintain appropriate controls, whether automated or manual, over computer-generated information.

In particular, management should evaluate whether appropriate internal controls have been implemented in any areas management has identified as posing

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[7] Some organizations may perform a periodic self-assessment using questionnaires or other techniques to identify and measure risks. Self-assessment may be less reliable in identifying the risk of fraud due to a lack of experience with fraud (although many organizations experience some form of fraud and abuse, material financial statement fraud or misappropriation of assets is a rare event for most) and because management may be unwilling to acknowledge openly that they might commit fraud given sufficient pressure and opportunity.

[8] The report of the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, *Internal Control—Integrated Framework*, provides reasonable criteria for management to use in evaluating the effectiveness of the entity's system of internal control.

a higher risk of fraudulent activity, as well as controls over the entity's financial reporting process. Because fraudulent financial reporting may begin in an interim period, management also should evaluate the appropriateness of internal controls over interim financial reporting.

Fraudulent financial reporting by upper-level management typically involves override of internal controls within the financial reporting process. Because management has the ability to override controls, or to influence others to perpetrate or conceal fraud, the need for a strong value system and a culture of ethical financial reporting becomes increasingly important. This helps create an environment in which other employees will decline to participate in committing a fraud and will use established communication procedures to report any requests to commit wrongdoing. The potential for management override also increases the need for appropriate oversight measures by the board of directors or audit committee, as discussed in the following section.

Fraudulent financial reporting by lower levels of management and employees may be deterred or detected by appropriate monitoring controls, such as having higher-level managers review and evaluate the financial results reported by individual operating units or subsidiaries. Unusual fluctuations in results of particular reporting units, or the lack of expected fluctuations, may indicate potential manipulation by departmental or operating unit managers or staff.

Developing an Appropriate Oversight Process

To effectively prevent or deter fraud, an entity should have an appropriate oversight function in place. Oversight can take many forms and can be performed by many within and outside the entity, under the overall oversight of the audit committee (or board of directors where no audit committee exists).

Audit Committee or Board of Directors

The audit committee (or the board of directors where no audit committee exists) should evaluate management's identification of fraud risks, implementation of antifraud measures, and creation of the appropriate "tone at the top." Active oversight by the audit committee can help to reinforce management's commitment to creating a culture with "zero tolerance" for fraud. An entity's audit committee also should ensure that senior management (in particular, the CEO) implements appropriate fraud deterrence and prevention measures to better protect investors, employees, and other stakeholders. The audit committee's evaluation and oversight not only helps make sure that senior management fulfills its responsibility, but also can serve as a deterrent to senior management engaging in fraudulent activity (that is, by ensuring an environment is created whereby any attempt by senior management to involve employees in committing or concealing fraud would lead promptly to reports from such employees to appropriate persons, including the audit committee).

The audit committee also plays an important role in helping the board of directors fulfill its oversight responsibilities with respect to the entity's financial reporting process and the system of internal control.[9] In exercising this oversight responsibility, the audit committee should consider the potential for management override of controls or other inappropriate influence over the financial reporting process. For example, the audit committee may obtain from

[9] See the Report of the NACD Blue Ribbon Commission on the Audit Committee, (Washington, D.C.: National Association of Corporate Directors, 2000). For the board's role in the oversight of risk management, see Report of the NACD Blue Ribbon Commission on Risk Oversight, (Washington, D.C.: National Association of Corporate Directors, 2002).

the internal auditors and independent auditors their views on management's involvement in the financial reporting process and, in particular, the ability of management to override information processed by the entity's financial reporting system (for example, the ability for management or others to initiate or record nonstandard journal entries). The audit committee also may consider reviewing the entity's reported information for reasonableness compared with prior or forecasted results, as well as with peers or industry averages. In addition, information received in communications from the independent auditors[10] can assist the audit committee in assessing the strength of the entity's internal control and the potential for fraudulent financial reporting.

As part of its oversight responsibilities, the audit committee should encourage management to provide a mechanism for employees to report concerns about unethical behavior, actual or suspected fraud, or violations of the entity's code of conduct or ethics policy. The committee should then receive periodic reports describing the nature, status, and eventual disposition of any fraud or unethical conduct. A summary of the activity, follow-up and disposition also should be provided to the full board of directors.

If senior management is involved in fraud, the next layer of management may be the most likely to be aware of it. As a result, the audit committee (and other directors) should consider establishing an open line of communication with members of management one or two levels below senior management to assist in identifying fraud at the highest levels of the organization or investigating any fraudulent activity that might occur.[11] The audit committee typically has the ability and authority to investigate any alleged or suspected wrongdoing brought to its attention. Most audit committee charters empower the committee to investigate any matters within the scope of its responsibilities, and to retain legal, accounting, and other professional advisers as needed to advise the committee and assist in its investigation.

All audit committee members should be financially literate, and each committee should have at least one financial expert. The financial expert should possess:

- An understanding of generally accepted accounting principles and audits of financial statements prepared under those principles. Such understanding may have been obtained either through education or experience. It is important for someone on the audit committee to have a working knowledge of those principles and standards.
- Experience in the preparation and/or the auditing of financial statements of an entity of similar size, scope and complexity as the entity on whose board the committee member serves. The experience would generally be as a chief financial officer, chief accounting officer, controller, or auditor of a similar entity. This background will provide a necessary understanding of the transactional and operational environment that produces the issuer's financial statements. It will also bring an understanding of what is involved in, for example, appropriate accounting estimates, accruals, and reserve provisions, and an appreciation of what is necessary to maintain a good internal control environment.

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[10] See section 325, *Communication of Internal Control Related Matters Noted in an Audit*, and Auditing Standard No. 16, *Communications with Audit Committees*. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

[11] *Report of the NACD Best Practices Council: Coping with Fraud and Other Illegal Activity, A Guide for Directors, CEOs, and Senior Managers* (1998) sets forth "basic principles" and "implementation approaches" for dealing with fraud and other illegal activity.

- Experience in internal governance and procedures of audit committees, obtained either as an audit committee member, a senior corporate manager responsible for answering to the audit committee, or an external auditor responsible for reporting on the execution and results of annual audits.

Management

Management is responsible for overseeing the activities carried out by employees, and typically does so by implementing and monitoring processes and controls such as those discussed previously. However, management also may initiate, participate in, or direct the commission and concealment of a fraudulent act. Accordingly, the audit committee (or the board of directors where no audit committee exists) has the responsibility to oversee the activities of senior management and to consider the risk of fraudulent financial reporting involving the override of internal controls or collusion (see discussion on the audit committee and board of directors above).

Public companies should include a statement in the annual report acknowledging management's responsibility for the preparation of the financial statements and for establishing and maintaining an effective system of internal control. This will help improve the public's understanding of the respective roles of management and the auditor. This statement has also been generally referred to as a "Management Report" or "Management Certificate." Such a statement can provide a convenient vehicle for management to describe the nature and manner of preparation of the financial information and the adequacy of the internal accounting controls. Logically, the statement should be presented in close proximity to the formal financial statements. For example, it could appear near the independent auditor's report, or in the financial review or management analysis section.

Internal Auditors

An effective internal audit team can be extremely helpful in performing aspects of the oversight function. Their knowledge about the entity may enable them to identify indicators that suggest fraud has been committed. The *Standards for the Professional Practice of Internal Auditing* (IIA Standards), issued by the Institute of Internal Auditors, state, "The internal auditor should have sufficient knowledge to identify the indicators of fraud but is not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud." Internal auditors also have the opportunity to evaluate fraud risks and controls and to recommend action to mitigate risks and improve controls. Specifically, the IIA Standards require internal auditors to assess risks facing their organizations. This risk assessment is to serve as the basis from which audit plans are devised and against which internal controls are tested. The IIA Standards require the audit plan to be presented to and approved by the audit committee (or board of directors where no audit committee exists). The work completed as a result of the audit plan provides assurance on which management's assertion about controls can be made.

Internal audits can be both a detection and a deterrence measure. Internal auditors can assist in the deterrence of fraud by examining and evaluating the adequacy and the effectiveness of the system of internal control, commensurate with the extent of the potential exposure or risk in the various segments of the organization's operations. In carrying out this responsibility, internal auditors should, for example, determine whether:

- The organizational environment fosters control consciousness.
- Realistic organizational goals and objectives are set.
- Written policies (for example, a code of conduct) exist that describe prohibited activities and the action required whenever violations are discovered.
- Appropriate authorization policies for transactions are established and maintained.
- Policies, practices, procedures, reports, and other mechanisms are developed to monito activities and safeguard assets, particularly in high-risk areas.
- Communication channels provide management with adequate and reliable information.
- Recommendations need to be made for the establishment or enhancement of cost-effective controls to help deter fraud.

Internal auditors may conduct proactive auditing to search for corruption, misappropriation of assets, and financial statement fraud. This may include the use of computer-assisted audit techniques to detect particular types of fraud. Internal auditors also can employ analytical and other procedures to isolate anomalies and perform detailed reviews of high-risk accounts and transactions to identify potential financial statement fraud. The internal auditors should have an independent reporting line directly to the audit committee, to enable them to express any concerns about management's commitment to appropriate internal controls or to report suspicions or allegations of fraud involving senior management.

Independent Auditors

Independent auditors can assist management and the board of directors (or audit committee) by providing an assessment of the entity's process for identifying, assessing, and responding to the risks of fraud. The board of directors (or audit committee) should have an open and candid dialogue with the independent auditors regarding management's risk assessment process and the system of internal control. Such a dialogue should include a discussion of the susceptibility of the entity to fraudulent financial reporting and the entity's exposure to misappropriation of assets.

Certified Fraud Examiners

Certified fraud examiners may assist the audit committee and board of directors with aspects of the oversight process either directly or as part of a team of internal auditors or independent auditors. Certified fraud examiners can provide extensive knowledge and experience about fraud that may not be available within a corporation. They can provide more objective input into management's evaluation of the risk of fraud (especially fraud involving senior management, such as financial statement fraud) and the development of appropriate antifraud controls that are less vulnerable to management override. They can assist the audit committee and board of directors in evaluating the fraud risk assessment and fraud prevention measures implemented by management. Certified fraud examiners also conduct examinations to resolve allegations or suspicions of fraud, reporting either to an appropriate level of management or to the audit committee or board of directors, depending upon the nature of the issue and the level of personnel involved.

Other Information

To obtain more information on fraud and implementing antifraud programs and controls, please go to the following Web sites where additional materials, guidance, and tools can be found.

American Institute of Certified Public Accountants	www.aicpa.org
Association of Certified Fraud Examiners	www.cfenet.com
Financial Executives International	www.fei.org
Information Systems Audit and Control Association	www.isaca.org
The Institute of Internal Auditors	www.theiia.org
Institute of Management Accountants	www.imanet.org
National Association of Corporate Directors	www.nacdonline.org
Society for Human Resource Management	www.shrm.org

Attachment 1: AICPA "CPA's Handbook of Fraud and Commercial Crime Prevention," An Organizational Code of Conduct

The following is an example of an organizational code of conduct, which includes definitions of what is considered unacceptable, and the consequences of any breaches thereof. The specific content and areas addressed in an entity's code of conduct should be specific to that entity.

Organizational Code of Conduct

The Organization and its employees must, at all times, comply with all applicable laws and regulations. The Organization will not condone the activities of employees who achieve results through violation of the law or unethical business dealings. This includes any payments for illegal acts, indirect contributions, rebates, and bribery. The Organization does not permit any activity that fails to stand the closest possible public scrutiny.

All business conduct should be well above the minimum standards required by law. Accordingly, employees must ensure that their actions cannot be interpreted as being, in any way, in contravention of the laws and regulations governing the Organization's worldwide operations.

Employees uncertain about the application or interpretation of any legal requirements should refer the matter to their superior, who, if necessary, should seek the advice of the legal department.

General Employee Conduct

The Organization expects its employees to conduct themselves in a businesslike manner. Drinking, gambling, fighting, swearing, and similar unprofessional activities are strictly prohibited while on the job.

Employees must not engage in sexual harassment, or conduct themselves in a way that could be construed as such, for example, by using inappropriate language, keeping or posting inappropriate materials in their work area, or accessing inappropriate materials on their computer.

Conflicts of Interest

The Organization expects that employees will perform their duties conscientiously, honestly, and in accordance with the best interests of the Organization. Employees must not use their position or the knowledge gained as a result of their position for private or personal advantage. Regardless of the

circumstances, if employees sense that a course of action they have pursued, are presently pursuing, or are contemplating pursuing may involve them in a conflict of interest with their employer, they should immediately communicate all the facts to their superior.

Outside Activities, Employment, and Directorships

All employees share a serious responsibility for the Organization's good public relations, especially at the community level. Their readiness to help with religious, charitable, educational, and civic activities brings credit to the Organization and is encouraged. Employees must, however, avoid acquiring any business interest or participating in any other activity outside the Organization that would, or would appear to:

- Create an excessive demand upon their time and attention, thus depriving the Organization of their best efforts on the job.
- Create a conflict of interest—an obligation, interest, or distraction—that may interfere with the independent exercise of judgment in the Organization's best interest.

Relationships With Clients and Suppliers

Employees should avoid investing in or acquiring a financial interest for their own accounts in any business organization that has a contractual relationship with the Organization, or that provides goods or services, or both to the Organization, if such investment or interest could influence or create the impression of influencing their decisions in the performance of their duties on behalf of the Organization.

Gifts, Entertainment, and Favors

Employees must not accept entertainment, gifts, or personal favors that could, in any way, influence, or appear to influence, business decisions in favor of any person or organization with whom or with which the Organization has, or is likely to have, business dealings. Similarly, employees must not accept any other preferential treatment under these circumstances because their position with the Organization might be inclined to, or be perceived to, place them under obligation.

Kickbacks and Secret Commissions

Regarding the Organization's business activities, employees may not receive payment or compensation of any kind, except as authorized under the Organization's remuneration policies. In particular, the Organization strictly prohibits the acceptance of kickbacks and secret commissions from suppliers or others. Any breach of this rule will result in immediate termination and prosecution to the fullest extent of the law.

Organization Funds and Other Assets

Employees who have access to Organization funds in any form must follow the prescribed procedures for recording, handling, and protecting money as detailed in the Organization's instructional manuals or other explanatory materials, or both. The Organization imposes strict standards to prevent fraud and dishonesty. If employees become aware of any evidence of fraud and dishonesty, they should immediately advise their superior or the Law Department so that the Organization can promptly investigate further.

When an employee's position requires spending Organization funds or incurring any reimbursable personal expenses, that individual must use good judgment on the Organization's behalf to ensure that good value is received for every expenditure.

Organization funds and all other assets of the Organization are for Organization purposes only and not for personal benefit. This includes the personal use of organizational assets, such as computers.

Organization Records and Communications

Accurate and reliable records of many kinds are necessary to meet the Organization's legal and financial obligations and to manage the affairs of the Organization. The Organization's books and records must reflect in an accurate and timely manner all business transactions. The employees responsible for accounting and recordkeeping must fully disclose and record all assets, liabilities, or both, and must exercise diligence in enforcing these requirements.

Employees must not make or engage in any false record or communication of any kind, whether internal or external, including but not limited to:

- False expense, attendance, production, financial, or similar reports and statements
- False advertising, deceptive marketing practices, or other misleading representations

Dealing With Outside People and Organizations

Employees must take care to separate their personal roles from their Organization positions when communicating on matters not involving Organization business. Employees must not use organization identification, stationery, supplies, and equipment for personal or political matters.

When communicating publicly on matters that involve Organization business, employees must not presume to speak for the Organization on any topic, unless they are certain that the views they express are those of the Organization, and it is the Organization's desire that such views be publicly disseminated.

When dealing with anyone outside the Organization, including public officials, employees must take care not to compromise the integrity or damage the reputation of either the Organization, or any outside individual, business, or government body.

Prompt Communications

In all matters relevant to customers, suppliers, government authorities, the public and others in the Organization, all employees must make every effort to achieve complete, accurate, and timely communications—responding promptly and courteously to all proper requests for information and to all complaints.

Privacy and Confidentiality

When handling financial and personal information about customers or others with whom the Organization has dealings, observe the following principles:

1. Collect, use, and retain only the personal information necessary for the Organization's business. Whenever possible, obtain any relevant information directly from the person concerned. Use only reputable and reliable sources to supplement this information.
2. Retain information only for as long as necessary or as required by law. Protect the physical security of this information.
3. Limit internal access to personal information to those with a legitimate business reason for seeking that information. Use only personal information for the purposes for which it was originally obtained. Obtain the consent of the person concerned before externally disclosing any personal information, unless legal process or contractual obligation provides otherwise.

Attachment 2: Financial Executives International Code of Ethics Statement

The mission of Financial Executives International (FEI) includes significant efforts to promote ethical conduct in the practice of financial management throughout the world. Senior financial officers hold an important and elevated role in corporate governance. While members of the management team, they are uniquely capable and empowered to ensure that all stakeholders' interests are appropriately balanced, protected, and preserved. This code provides principles that members are expected to adhere to and advocate. They embody rules regarding individual and peer responsibilities, as well as responsibilities to employers, the public, and other stakeholders.

All members of FEI will:

1. Act with honesty and integrity, avoiding actual or apparent conflicts of interest in personal and professional relationships.
2. Provide constituents with information that is accurate, complete, objective, relevant, timely, and understandable.
3. Comply with rules and regulations of federal, state, provincial, and local governments, and other appropriate private and public regulatory agencies.
4. Act in good faith; responsibly; and with due care, competence, and diligence, without misrepresenting material facts or allowing one's independent judgment to be subordinated.
5. Respect the confidentiality of information acquired in the course of one's work except when authorized or otherwise legally obligated to disclose. Confidential information acquired in the course of one's work will not be used for personal advantage.
6. Share knowledge and maintain skills important and relevant to constituents' needs.
7. Proactively promote ethical behavior as a responsible partner among peers, in the work environment, and in the community.
8. Achieve responsible use of and control over all assets and resources employed or entrusted.

AU Section 317

Illegal Acts by Clients

(Supersedes section 328)

Source: SAS No. 54; Auditing Standard Nos. 8–15; Auditing Standard No. 16.

See section 9317 for interpretations of this section.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

.01 This section prescribes the nature and extent of the consideration an independent auditor should give to the possibility of illegal acts by a client in an audit of financial statements in accordance with generally accepted auditing standards. The section also provides guidance on the auditor's responsibilities when a possible illegal act is detected.

Definition of Illegal Acts

.02 The term *illegal acts*, for purposes of this section, refers to violations of laws or governmental regulations. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity. Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities.

Dependence on Legal Judgment

.03 Whether an act is, in fact, illegal is a determination that is normally beyond the auditor's professional competence. An auditor, in reporting on financial statements, presents himself as one who is proficient in accounting and auditing. The auditor's training, experience, and understanding of the client and its industry may provide a basis for recognition that some client acts coming to his attention may be illegal. However, the determination as to whether a particular act is illegal would generally be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law.

Relation to Financial Statements

.04 Illegal acts vary considerably in their relation to the financial statements. Generally, the further removed an illegal act is from the events and transactions ordinarily reflected in financial statements, the less likely the auditor is to become aware of the act or to recognize its possible illegality.

.05 The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. For example, tax laws affect accruals and the amount recognized as expense in the accounting period; applicable laws and regulations may affect the amount of revenue accrued under government contracts. However, the auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statements

assertions rather than from the perspective of legality *per se*. The auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud as described in section 110, *Responsibilities and Functions of the Independent Auditor*.

.06 Entities may be affected by many other laws or regulations, including those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, and price-fixing or other antitrust violations. Generally, these laws and regulations relate more to an entity's operating aspects than to its financial and accounting aspects, and their financial statement effect is indirect. An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality. For example, securities may be purchased or sold based on inside information. While the direct effects of the purchase or sale may be recorded appropriately, their indirect effect, the possible contingent liability for violating securities laws, may not be appropriately disclosed. Even when violations of such laws and regulations can have consequences material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he is informed by the client, or there is evidence of a governmental agency investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.

The Auditor's Consideration of the Possibility of Illegal Acts

.07 As explained in paragraph .05, certain illegal acts have a direct and material effect on the determination of financial statement amounts. Other illegal acts, such as those described in paragraph .06, may, in particular circumstances, be regarded as having material but indirect effects on financial statements. The auditor's responsibility with respect to detecting, considering the financial statement effects of, and reporting these other illegal acts is described in this section. These other illegal acts are hereinafter referred to simply as *illegal acts*. The auditor should be aware of the possibility that such illegal acts may have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. However, because of the characteristics of illegal acts explained above, an audit made in accordance with generally accepted auditing standards provides no assurance that illegal acts will be detected or that any contingent liabilities that may result will be disclosed.

Audit Procedures in the Absence of Evidence Concerning Possible Illegal Acts

.08 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

Normally, an audit in accordance with generally accepted auditing standards does not include audit procedures specifically designed to detect illegal acts. However, procedures applied for the purpose of forming an opinion on the financial statements may bring possible illegal acts to the auditor's attention.

For example, such procedures include reading minutes; inquiring of the client's management and legal counsel concerning litigation, claims, and assessments; performing substantive tests of details of transactions or balances. The auditor should make inquiries of management and the audit committee[1] concerning the client's compliance with laws and regulations and knowledge of violations or possible violations of laws or regulations. Where applicable, the auditor should also inquire of management concerning—

- The client's policies relative to the prevention of illegal acts.
- The use of directives issued by the client and periodic representations obtained by the client from management at appropriate levels of authority concerning compliance with laws and regulations.

The auditor also obtains written representations from management concerning the absence of violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency. (See section 333, *Management Representations*.) The auditor need perform no further procedures in this area absent specific information concerning possible illegal acts.

Specific Information Concerning Possible Illegal Acts

.09 In applying audit procedures and evaluating the results of those procedures, the auditor may encounter specific information that may raise a question concerning possible illegal acts, such as the following:

- Unauthorized transactions, improperly recorded transactions, or transactions not recorded in a complete or timely manner in order to maintain accountability for assets
- Investigation by a governmental agency, an enforcement proceeding, or payment of unusual fines or penalties
- Violations of laws or regulations cited in reports of examinations by regulatory agencies that have been made available to the auditor
- Large payments for unspecified services to consultants, affiliates, or employees
- Sales commissions or agents' fees that appear excessive in relation to those normally paid by the client or to the services actually received
- Unusually large payments in cash, purchases of bank cashiers' checks in large amounts payable to bearer, transfers to numbered bank accounts, or similar transactions
- Unexplained payments made to government officials or employees
- Failure to file tax returns or pay government duties or similar fees that are common to the entity's industry or the nature of its business

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[1] For this standard, audit committee is defined as a committee (or equivalent body) established by and among the board of directors of an entity for the purpose of overseeing the accounting and financial reporting processes of the entity and audits of the financial statements of the entity; if no such committee exists with respect to the entity, the entire board of directors of the entity. For audits of nonissuers, if no such committee or board of directors (or equivalent body) exists with respect to the entity, the person(s) who oversee the accounting and financial reporting processes of the entity and audits of the financial statements of the entity. *[Footnote added, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

Audit Procedures in Response to Possible Illegal Acts

.10 When the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. In doing so, the auditor should inquire of management at a level above those involved, if possible. If management does not provide satisfactory information that there has been no illegal act, the auditor should—

a. Consult with the client's legal counsel or other specialists about the application of relevant laws and regulations to the circumstances and the possible effects on the financial statements. Arrangements for such consultation with client's legal counsel should be made by the client.

b. Apply additional procedures, if necessary, to obtain further understanding of the nature of the acts.

.11 The additional audit procedures considered necessary, if any, might include procedures such as the following:

a. Examine supporting documents, such as invoices, canceled checks, and agreements and compare with accounting records.

b. Confirm significant information concerning the matter with the other party to the transaction or with intermediaries, such as banks or lawyers.

c. Determine whether the transaction has been properly authorized.

d. Consider whether other similar transactions or events may have occurred, and apply procedures to identify them.

The Auditor's Response to Detected Illegal Acts

.12 When the auditor concludes, based on information obtained and, if necessary, consultation with legal counsel, that an illegal act has or is likely to have occurred, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit.

The Auditor's Consideration of Financial Statement Effect

.13 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

In evaluating the materiality of an illegal act that comes to his attention, the auditor should consider both the quantitative and qualitative materiality of the act. 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.

.14 The auditor should consider the effect of an illegal act on the amounts presented in financial statements including contingent monetary effects, such as fines, penalties and damages. Loss contingencies resulting from illegal acts that may be required to be disclosed should be evaluated in the same manner as other loss contingencies. Examples of loss contingencies that may arise from an illegal act are: threat of expropriation of assets, enforced discontinuance of operations in another country, and litigation.

.15 The auditor should evaluate the adequacy of disclosure in the financial statements of the potential effects of an illegal act on the entity's operations.

If material revenue or earnings are derived from transactions involving illegal acts, or if illegal acts create significant unusual risks associated with material revenue or earnings, such as loss of a significant business relationship, that information should be considered for disclosure.

Implications for Audit

.16 The auditor should consider the implications of an illegal act in relation to other aspects of the audit, particularly the reliability of representations of management. The implications of particular illegal acts will depend on the relationship of the perpetration and concealment, if any, of the illegal act to specific control procedures and the level of management or employees involved.

Communication With the Audit Committee

.17 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

The auditor should assure himself that the audit committee is adequately informed as soon as practicable and prior to the issuance of the auditor's report with respect to illegal acts that come to the auditor's attention.[1] The auditor need not communicate matters that are clearly inconsequential and may reach agreement in advance with the audit committee on the nature of such matters to be communicated. The communication should describe the act, the circumstances of its occurrence, and the effect on the financial statements. Senior management may wish to have its remedial actions communicated to the audit committee simultaneously. Possible remedial actions include disciplinary action against involved personnel, seeking restitution, adoption of preventive or corrective company policies, and modifications of specific control activities. If senior management is involved in an illegal act, the auditor should communicate directly with the audit committee. The communication may be oral or written. If the communication is oral, the auditor should document it.

Effect on the Auditor's Report

.18 If the auditor concludes that an illegal act has a material effect on the financial statements, and the act has not been properly accounted for or disclosed, the auditor should express a qualified opinion or an adverse opinion on the financial statements taken as a whole, depending on the materiality of the effect on the financial statements.

.19 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

If the auditor is precluded by the client from obtaining sufficient appropriate evidential matter to evaluate whether an illegal act that could be material to the financial statements has, or is likely to have, occurred, the auditor generally should disclaim an opinion on the financial statements.

.20 If the client refuses to accept the auditor's report as modified for the circumstances described in paragraphs .18 and .19, the auditor should withdraw from the engagement and indicate the reasons for withdrawal in writing to the audit committee or board of directors.

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[1] *[Footnote deleted, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

.21 The auditor may be unable to determine whether an act is illegal because of limitations imposed by the circumstances rather than by the client or because of uncertainty associated with interpretation of applicable laws or regulations or surrounding facts. In these circumstances, the auditor should consider the effect on his report.[2]

Other Considerations in an Audit in Accordance With Generally Accepted Auditing Standards

.22 In addition to the need to withdraw from the engagement, as described in paragraph .20, the auditor may conclude that withdrawal is necessary when the client does not take the remedial action that the auditor considers necessary in the circumstances even when the illegal act is not material to the financial statements. Factors that should affect the auditor's conclusion include the implications of the failure to take remedial action, which may affect the auditor's ability to rely on management representations, and the effects of continuing association with the client. In reaching a conclusion on such matters, the auditor may wish to consult with his own legal counsel.

.23 Disclosure of an illegal act to parties other than the client's senior management and its audit committee or board of directors is not ordinarily part of the auditor's responsibility, and such disclosure would be precluded by the auditor's ethical or legal obligation of confidentiality, unless the matter affects his opinion on the financial statements. The auditor should recognize, however, that in the following circumstances a duty to notify parties outside the client may exist:[3]

a. When the entity reports an auditor change under the appropriate securities law on Form 8-K[4]

b. To a successor auditor when the successor makes inquiries in accordance with section 315, *Communications Between Predecessor and Successor Auditors*[5]

c. In response to a subpoena

d. To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive financial assistance from a government agency

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with legal counsel before discussing illegal acts with parties outside the client.

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[2] See section 508, *Reports on Audited Financial Statements*.

[3] Auditors may be required, under certain circumstances, pursuant to the Private Securities Litigation Reform Act of 1995 (codified in section 10A(b)1 of the Securities Exchange Act of 1934) to make a report to the Securities and Exchange Commission relating to an illegal act that has a material effect on the financial statements. [Footnote added, July 1997, to reflect conforming changes necessary due to the issuance of the Private Securities Litigation Reform Act of 1995.]

[4] Disclosure to the Securities and Exchange Commission may be necessary if, among other matters, the auditor withdraws because the board of directors has not taken appropriate remedial action. Such failure may be a reportable disagreement on Form 8-K. [Footnote renumbered, July 1997, to reflect conforming changes necessary due to the issuance of the Private Securities Litigation Reform Act of 1995.]

[5] In accordance with section 315, communications between predecessor and successor auditors require the specific permission of the client. [Footnote renumbered, July 1997, to reflect conforming changes necessary due to the issuance of the Private Securities Litigation Reform Act of 1995.]

Responsibilities in Other Circumstances

.24 An auditor may accept an engagement that entails a greater responsibility for detecting illegal acts than that specified in this section. For example, a governmental unit may engage an independent auditor to perform an audit in accordance with the Single Audit Act of 1984. In such an engagement, the independent auditor is responsible for testing and reporting on the governmental unit's compliance with certain laws and regulations applicable to Federal financial assistance programs. Also, an independent auditor may undertake a variety of other special engagements. For example, a corporation's board of directors or its audit committee may engage an auditor to apply agreed-upon procedures and report on compliance with the corporation's code of conduct under the attestation standards.

Effective Date

.25 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

AU Section 9317

Illegal Acts by Clients: Auditing Interpretations of Section 317

1. Consideration of Internal Control in a Financial Statement Audit and the Foreign Corrupt Practices Act

.01 *Question*—The second standard of field work requires the auditor to obtain a sufficient understanding of internal control to plan the audit and to determine the nature, timing, and extent of tests to be performed. Is the auditor of an entity subject to the Securities Exchange Act of 1934 required, because of the *Foreign Corrupt Practices Act of 1977* and the provisions of section 317, to expand his consideration of internal control beyond that which is required by the second standard of field work?

.02 *Interpretation*—No. There is nothing in the Act or the related legislative history that purports to alter the auditor's duty to his client or the purpose of his consideration of internal control. The Act creates express new duties only for companies subject to the Securities Exchange Act of 1934, not for auditors.

[Issue Date: October, 1978.]

2. Material Weaknesses in Internal Control and the Foreign Corrupt Practices Act

.03 *Question*—What course of action should be followed by the auditor of an entity subject to the internal accounting control provision of the *Foreign Corrupt Practices Act of 1977* to comply with section 317 when a material weakness in internal control comes to his attention?

.04 *Interpretation*—The standards applied by an auditor in determining a material weakness in internal control may differ from the standards for determining a violation of the Act. Nevertheless, a specific material weakness may ultimately be determined to be a violation and, hence, an illegal act. Therefore, the auditor should inquire of the client's management and consult with the client's legal counsel as to whether the material weakness is a violation of the Act.

.05 In consultation with management and legal counsel, consideration should be given to corrective action taken or in process. If management has concluded that corrective action for a material weakness is not practicable, consideration should be given to the reasons underlying that conclusion, including management's evaluation of the costs of correction in relation to the expected benefit to be derived.[1] If it is determined that there has been a violation of

[1] The legislative history of the Act indicates that cost-benefit considerations are appropriate in determining compliance with the accounting provisions of the Act. For example, the Senate committee report stated that "the size of the business, diversity of operations, degree of centralization of financial and operating management, amount of contact by top management with day-to-day operations, and numerous other circumstances are factors which management must consider in establishing and maintaining an internal accounting control system."

the Act and appropriate consideration is not given to the violation, the auditor should consider withdrawing from the current engagement or dissociating himself from any future relationship with the client (see section 317.22).

.06 A violation of the internal accounting control provision of the Act would not, in and of itself, have a direct effect on amounts presented in audited financial statements. However, the contingent monetary effect on an entity ultimately determined to have willfully violated the internal accounting control provision of the Act could be fines of up to $10,000 for the violation. The auditor should consider the materiality of such contingent monetary effect in relation to the audited financial statements taken as a whole. Other loss contingencies, as defined by FASB Statement No. 5 [AC section C59], ordinarily would not result from a weakness in internal control which gives rise to such a violation of the Act.

[Issue Date: October, 1978.]

AU Section 319

Consideration of Internal Control in a Financial Statement Audit

[This section was superseded, effective December 15, 2010, by PCAOB Auditing Standard Nos. 8–15. See PCAOB Release No. 2010-004.]

AU Section 322

The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements

(Supersedes SAS No. 9)

Source: SAS No. 65; Auditing Standard No. 2; Auditing Standard No. 5; Auditing Standard Nos. 8–15.

Effective for audits of financial statements for periods ending after December 15, 1991, unless otherwise indicated.

.01 The auditor considers many factors in determining the nature, timing, and extent of auditing procedures to be performed in an audit of an entity's financial statements. One of the factors is the existence of an internal audit function.[1] This section provides the auditor with guidance on considering the work of internal auditors and on using internal auditors to provide direct assistance to the auditor in an audit performed in accordance with generally accepted auditing standards.

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]

> Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 16–19 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, for discussion on using the work of others to alter the nature, timing, and extent of the work that otherwise would have been performed to test controls.

Roles of the Auditor and the Internal Auditors

.02 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

One of the auditor's responsibilities in an audit conducted in accordance with generally accepted auditing standards is to obtain sufficient appropriate evidential matter to provide a reasonable basis for the opinion on the entity's financial statements. In fulfilling this responsibility, the auditor maintains independence from the entity.[2]

.03 Internal auditors are responsible for providing analyses, evaluations, assurances, recommendations, and other information to the entity's management and board of directors or to others with equivalent authority and

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[1] An *internal audit function* may consist of one or more individuals who perform internal auditing activities within an entity. This section is not applicable to personnel who have the title *internal auditor* but who do not perform internal auditing activities as described herein.

[2] Although internal auditors are not independent from the entity, The Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing* defines internal auditing as an independent appraisal function and requires internal auditors to be independent of the activities they audit. This concept of independence is different from the independence the auditor maintains under the AICPA Code of Professional Conduct.

responsibility. To fulfill this responsibility, internal auditors maintain objectivity with respect to the activity being audited.

Obtaining an Understanding of the Internal Audit Function

.04 An important responsibility of the internal audit function is to monitor the performance of an entity's controls. When obtaining an understanding of internal control,[3] the auditor should obtain an understanding of the internal audit function sufficient to identify those internal audit activities that are relevant to planning the audit. The extent of the procedures necessary to obtain this understanding will vary, depending on the nature of those activities.

.05 The auditor ordinarily should make inquiries of appropriate management and internal audit personnel about the internal auditors'—

a. Organizational status within the entity.

b. Application of professional standards (see paragraph .11).

c. Audit plan, including the nature, timing, and extent of audit work.

d. Access to records and whether there are limitations on the scope of their activities.

In addition, the auditor might inquire about the internal audit function's charter, mission statement, or similar directive from management or the board of directors. This inquiry will normally provide information about the goals and objectives established for the internal audit function.

.06 Certain internal audit activities may not be relevant to an audit of the entity's financial statements. For example, the internal auditors' procedures to evaluate the efficiency of certain management decision-making processes are ordinarily not relevant to a financial statement audit.

.07 Relevant activities are those that provide evidence about the design and effectiveness of controls that pertain to the entity's ability to initiate, record, process, and report financial data consistent with the assertions embodied in the financial statements or that provide direct evidence about potential misstatements of such data. The auditor may find the results of the following procedures helpful in assessing the relevancy of internal audit activities:

a. Considering knowledge from prior-year audits

b. Reviewing how the internal auditors allocate their audit resources to financial or operating areas in response to their risk-assessment process

c. Reading internal audit reports to obtain detailed information about the scope of internal audit activities

[Revised, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

.08 If, after obtaining an understanding of the internal audit function, the auditor concludes that the internal auditors' activities are not relevant to the financial statement audit, the auditor does not have to give further consideration to the internal audit function unless the auditor requests direct assistance from the internal auditors as described in paragraph .27. Even if some of the

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[3] 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. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.*]

internal auditors' activities are relevant to the audit, the auditor may conclude that it would not be efficient to consider further the work of the internal auditors. If the auditor decides that it would be efficient to consider how the internal auditors' work might affect the nature, timing, and extent of audit procedures, the auditor should assess the competence and objectivity of the internal audit function in light of the intended effect of the internal auditors' work on the audit.

Assessing the Competence and Objectivity of the Internal Auditors

Competence of the Internal Auditors

.09 When assessing the internal auditors' competence, the auditor should obtain or update information from prior years about such factors as—

- Educational level and professional experience of internal auditors.
- Professional certification and continuing education.
- Audit policies, programs, and procedures.
- Practices regarding assignment of internal auditors.
- Supervision and review of internal auditors' activities.
- Quality of working-paper documentation, reports, and recommendations.
- Evaluation of internal auditors' performance.

Objectivity of the Internal Auditors

.10 When assessing the internal auditors' objectivity, the auditor should obtain or update information from prior years about such factors as—

- The organizational status of the internal auditor responsible for the internal audit function, including—
  - — Whether the internal auditor reports to an officer of sufficient status to ensure broad audit coverage and adequate consideration of, and action on, the findings and recommendations of the internal auditors.
  - — Whether the internal auditor has direct access and reports regularly to the board of directors, the audit committee, or the owner-manager.
  - — Whether the board of directors, the audit committee, or the owner-manager oversees employment decisions related to the internal auditor.
- Policies to maintain internal auditors' objectivity about the areas audited, including—
  - — Policies prohibiting internal auditors from auditing areas where relatives are employed in important or audit-sensitive positions.
  - — Policies prohibiting internal auditors from auditing areas where they were recently assigned or are scheduled to be assigned on completion of responsibilities in the internal audit function.

Assessing Competence and Objectivity

.11 In assessing competence and objectivity, the auditor usually considers information obtained from previous experience with the internal audit function, from discussions with management personnel, and from a recent external quality review, if performed, of the internal audit function's activities. The auditor may also use professional internal auditing standards[4] as criteria in making the assessment. The auditor also considers the need to test the effectiveness of the factors described in paragraphs .09 and .10. The extent of such testing will vary in light of the intended effect of the internal auditors' work on the audit. If the auditor determines that the internal auditors are sufficiently competent and objective, the auditor should then consider how the internal auditors' work may affect the audit.

Effect of the Internal Auditors' Work on the Audit

.12 The internal auditors' work may affect the nature, timing, and extent of the audit, including—

- Procedures the auditor performs when obtaining an understanding of the entity's internal control (paragraph .13).
- Procedures the auditor performs when assessing risk (paragraphs .14 through .16).
- Substantive procedures the auditor performs (paragraph .17).

When the work of the internal auditors is expected to affect the audit, the guidance in paragraphs .18 through .26 should be followed for considering the extent of the effect, coordinating audit work with internal auditors, and evaluating and testing the effectiveness of internal auditors' work.

Understanding of Internal Control

.13 The auditor obtains a sufficient understanding of the design of controls relevant to the audit of financial statements to plan the audit and to determine whether they have been placed in operation. Since a primary objective of many internal audit functions is to review, assess, and monitor controls, the procedures performed by the internal auditors in this area may provide useful information to the auditor. For example, internal auditors may develop a flowchart of a new computerized sales and receivables system. The auditor may review the flowchart to obtain information about the design of the related controls. In addition, the auditor may consider the results of procedures performed by the internal auditors on related controls to obtain information about whether the controls have been placed in operation. [Revised, February 1997, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 78.]

Risk Assessment

.14 The auditor assesses the risk of material misstatement at both the financial-statement level and the account-balance or class-of-transaction level.

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[4] Standards have been developed for the professional practice of internal auditing by The Institute of Internal Auditors and the General Accounting Office. These standards are meant to (*a*) impart an understanding of the role and responsibilities of internal auditing to all levels of management, boards of directors, public bodies, external auditors, and related professional organizations; (*b*) permit measurement of internal auditing performance; and (*c*) improve the practice of internal auditing.

Financial-Statement Level

.15 At the financial-statement level, the auditor makes an overall assessment of the risk of material misstatement. When making this assessment, the auditor should recognize that certain controls may have a pervasive effect on many financial statement assertions. The control environment and accounting system often have a pervasive effect on a number of account balances and transaction classes and therefore can affect many assertions. The auditor's assessment of risk at the financial-statement level often affects the overall audit strategy. The entity's internal audit function may influence this overall assessment of risk as well as the auditor's resulting decisions concerning the nature, timing, and extent of auditing procedures to be performed. For example, if the internal auditors' plan includes relevant audit work at various locations, the auditor may coordinate work with the internal auditors (see paragraph .23) and reduce the number of the entity's locations at which the auditor would otherwise need to perform auditing procedures.

Account-Balance or Class-of-Transaction Level

.16 *[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2004, for accelerated filers, and on or after July 15, 2005, for all other issuers. See PCAOB Release No. 2004-008.]*

At the account-balance or class-of-transaction level, the auditor performs procedures to obtain and evaluate evidential matter concerning management's assertions. The auditor assesses control risk for each of the relevant financial statement assertions related to all significant accounts and disclosures in the financial statements and performs tests of controls to support assessments below the maximum. When planning and performing tests of controls, the auditor may consider the results of procedures planned or performed by the internal auditors. For example, the internal auditors' scope may include tests of controls for the completeness of accounts payable. The results of internal auditors' tests may provide appropriate information about the effectiveness of controls and change the nature, timing, and extent of testing the auditor would otherwise need to perform.

Substantive Procedures

.17 Some procedures performed by the internal auditors may provide direct evidence about material misstatements in assertions about specific account balances or classes of transactions. For example, the internal auditors, as part of their work, may confirm certain accounts receivable and observe certain physical inventories. The results of these procedures can provide evidence the auditor may consider in restricting detection risk for the related assertions. Consequently, the auditor may be able to change the timing of the confirmation procedures, the number of accounts receivable to be confirmed, or the number of locations of physical inventories to be observed.

Extent of the Effect of the Internal Auditors' Work

.18 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Even though the internal auditors' work may affect the auditor's procedures, the auditor should perform procedures to obtain sufficient, appropriate, evidential matter to support the auditor's report. Evidence obtained through the auditor's direct personal knowledge, including physical examination, observation,

computation, and inspection, is generally more persuasive than information obtained indirectly.[5]

.19 The responsibility to report on the financial statements rests solely with the auditor. Unlike the situation in which the auditor uses the work of other independent auditors,[6] this responsibility cannot be shared with the internal auditors. Because the auditor has the ultimate responsibility to express an opinion on the financial statements, judgments about assessments of inherent and control risks, the materiality of misstatements, the sufficiency of tests performed, the evaluation of significant accounting estimates, and other matters affecting the auditor's report should always be those of the auditor.

.20 In making judgments about the extent of the effect of the internal auditors' work on the auditor's procedures, the auditor considers—

a. The materiality of financial statement amounts—that is, account balances or classes of transactions.

b. The risk (consisting of inherent risk and control risk) of material misstatement of the assertions related to these financial statement amounts.

c. The degree of subjectivity involved in the evaluation of the audit evidence gathered in support of the assertions.[7]

As the materiality of the financial statement amounts increases and either the risk of material misstatement or the degree of subjectivity increases, the need for the auditor to perform his or her own tests of the assertions increases. As these factors decrease, the need for the auditor to perform his or her own tests of the assertions decreases.

[Note deleted, effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]

.21 For assertions related to material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is high, the auditor should perform sufficient procedures to fulfill the responsibilities described in paragraphs .18 and .19. In determining these procedures, the auditor gives consideration to the results of work (either tests of controls or substantive tests) performed by internal auditors on those particular assertions. However, for such assertions, the consideration of internal auditors' work cannot alone reduce audit risk to an acceptable level to eliminate the necessity to perform tests of those assertions directly by the auditor. Assertions about the valuation of assets and liabilities involving significant accounting estimates, and about the existence and disclosure of related-party transactions, contingencies, uncertainties, and subsequent events, are examples of assertions that might have a high risk of material misstatement or involve a high degree of subjectivity in the evaluation of audit evidence.

.22 On the other hand, for certain assertions related to less material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is low, the auditor may decide, after considering the circumstances and the results of work (either

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[5] See paragraph 8 of Auditing Standard No. 15, *Audit Evidence*. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[6] See section 543, *Part of Audit Performed by Other Independent Auditors*.

[7] For some assertions, such as existence and occurrence, the evaluation of audit evidence is generally objective. More subjective evaluation of the audit evidence is often required for other assertions, such as the valuation and disclosure assertions.

tests of controls or substantive tests) performed by internal auditors on those particular assertions, that audit risk has been reduced to an acceptable level and that testing of the assertions directly by the auditor may not be necessary. Assertions about the existence of cash, prepaid assets, and fixed-asset additions are examples of assertions that might have a low risk of material misstatement or involve a low degree of subjectivity in the evaluation of audit evidence.

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]

> Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 18–19 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, regarding assessing the interrelationship of the nature of the controls and the competence and objectivity of those who performed the work.

Coordination of the Audit Work With Internal Auditors

.23 If the work of the internal auditors is expected to have an effect on the auditor's procedures, it may be efficient for the auditor and the internal auditors to coordinate their work by—

- Holding periodic meetings.
- Scheduling audit work.
- Providing access to internal auditors' working papers.
- Reviewing audit reports.
- Discussing possible accounting and auditing issues.

Evaluating and Testing the Effectiveness of Internal Auditors' Work

.24 The auditor should perform procedures to evaluate the quality and effectiveness of the internal auditors' work, as described in paragraphs .12 through .17, that significantly affects the nature, timing, and extent of the auditor's procedures. The nature and extent of the procedures the auditor should perform when making this evaluation are a matter of judgment depending on the extent of the effect of the internal auditors' work on the auditor's procedures for significant account balances or classes of transactions.

.25 In developing the evaluation procedures, the auditor should consider such factors as whether the internal auditors'—

- Scope of work is appropriate to meet the objectives.
- Audit programs are adequate.
- Working papers adequately document work performed, including evidence of supervision and review.
- Conclusions are appropriate in the circumstances.
- Reports are consistent with the results of the work performed.

.26 In making the evaluation, the auditor should test some of the internal auditors' work related to the significant financial statement assertions. These tests may be accomplished by either (*a*) examining some of the controls, transactions, or balances that the internal auditors examined or (*b*) examining similar

controls, transactions, or balances not actually examined by the internal auditors. In reaching conclusions about the internal auditors' work, the auditor should compare the results of his or her tests with the results of the internal auditors' work. The extent of this testing will depend on the circumstances and should be sufficient to enable the auditor to make an evaluation of the overall quality and effectiveness of the internal audit work being considered by the auditor.

Using Internal Auditors to Provide Direct Assistance to the Auditor

.27 In performing the audit, the auditor may request direct assistance from the internal auditors. This direct assistance relates to work the auditor specifically requests the internal auditors to perform to complete some aspect of the auditor's work. For example, internal auditors may assist the auditor in obtaining an understanding of internal control or in performing tests of controls or substantive tests, consistent with the guidance about the auditor's responsibility in paragraphs .18 through .22. When direct assistance is provided, the auditor should assess the internal auditors' competence and objectivity (see paragraphs .09 through .11) and supervise,[8] review, evaluate, and test the work performed by internal auditors to the extent appropriate in the circumstances. The auditor should inform the internal auditors of their responsibilities, the objectives of the procedures they are to perform, and matters that may affect the nature, timing, and extent of audit procedures, such as possible accounting and auditing issues. The auditor should also inform the internal auditors that all significant accounting and auditing issues identified during the audit should be brought to the auditor's attention.

Effective Date

.28 This section is effective for audits of financial statements for periods ending after December 15, 1991. Early application of the provisions of this section is permissible.

[8] See Auditing Standard No. 10, *Supervision of the Audit Engagement*, for the type of supervisory procedures to apply. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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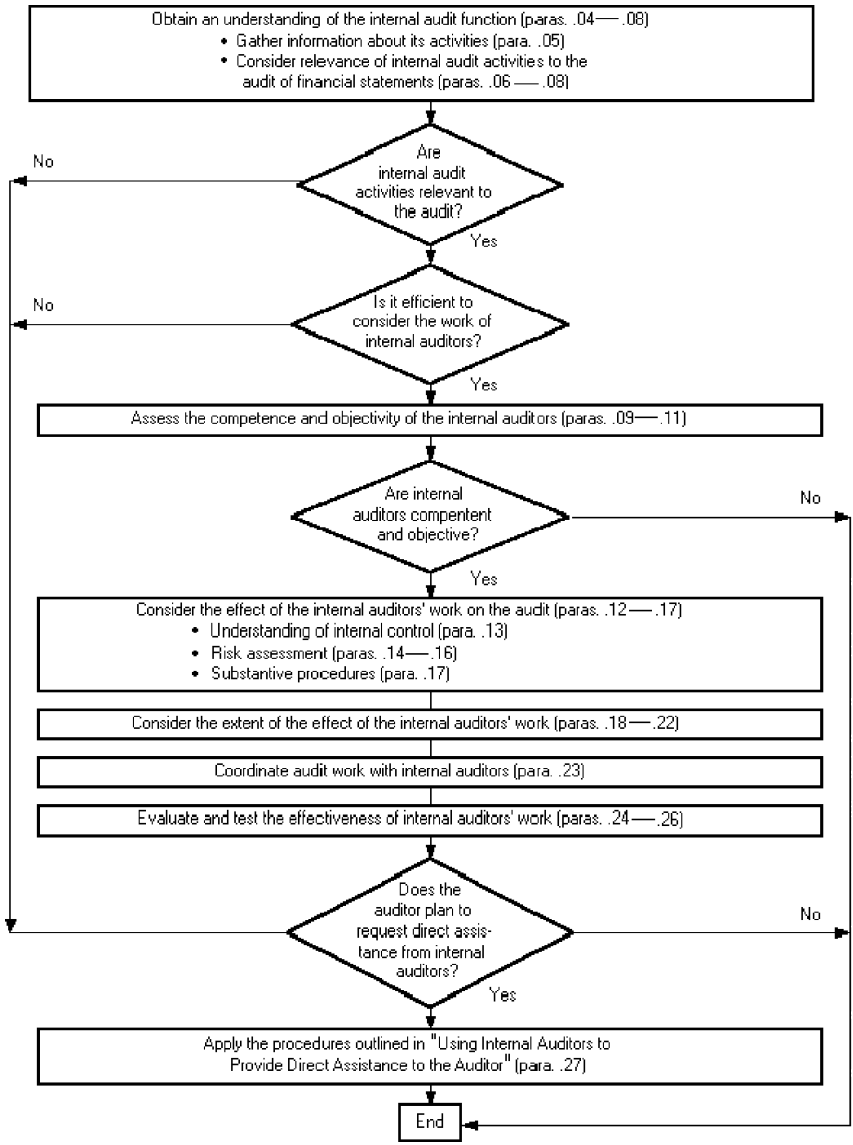
Appendix

The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements



AU Section 324

Service Organizations[*]

(Supersedes SAS No. 44)

Sources: SAS No. 70; SAS No. 78; SAS No. 88; SAS No. 98; Auditing Standard No. 2; Auditing Standard No. 5; Auditing Standard Nos. 8–15.

See section 9324 for interpretations of this section.

Effective for service auditors' reports dated after March 31, 1993, unless otherwise indicated.

Introduction and Applicability

.01 This section provides guidance on the factors an independent auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions. This section also provides guidance for independent auditors who issue reports on the processing of transactions by a service organization for use by other auditors.

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs B17–B27 of Appendix B, *Special Topics*, of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, regarding the use of service organizations.

.02 For purposes of this section, the following definitions apply:

- *User organization*—The entity that has engaged a service organization and whose financial statements are being audited
- *User auditor*—The auditor who reports on the financial statements of the user organization
- *Service organization*—The entity (or segment of an entity) that provides services to a user organization that are part of the user organization's information system
- *Service auditor*—The auditor who reports on controls of a service organization that may be relevant to a user organization's internal control as it relates to an audit of financial statements
- *Report on controls placed in operation*—A service auditor's report on a service organization's description of its controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, on whether such controls were suitably designed to achieve specified control objectives, and on whether they had been placed in operation as of a specific date

[*] Title amended, effective December 1999, by Statement on Auditing Standards No. 88.

- *Report on controls placed in operation and tests of operating effectiveness*—A service auditor's report on a service organization's description of its controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements,[1] on whether such controls were suitably designed to achieve specified control objectives, on whether they had been placed in operation as of a specific date, and on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

[Revised, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

.03 The guidance in this section is applicable to the audit of the financial statements of an entity that obtains services from another organization that are part of its information system. A service organization's services are part of an entity's information system if they affect any of the following:

- The classes of transactions in the entity's operations that are significant to the entity's financial statements
- The procedures, both automated and manual, by which the entity's transactions are initiated, recorded, processed, and reported from their occurrence to their inclusion in the financial statements
- The related accounting records, whether electronic or manual, supporting information, and specific accounts in the entity's financial statements involved in initiating, recording, processing and reporting the entity's transactions
- How the entity's information system captures other events and conditions that are significant to the financial statements
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures

Service organizations that provide such services include, for example, bank trust departments that invest and service assets for employee benefit plans or for others, mortgage bankers that service mortgages for others, and application service providers that provide packaged software applications and a technology environment that enables customers to process financial and operational transactions. The guidance in this section may also be relevant to situations in which an organization develops, provides, and maintains the software used by client organizations. The provisions of this section are not intended to apply to situations in which the services provided are limited to executing client organization transactions that are specifically authorized by the client, such as the processing of checking account transactions by a bank or the execution of securities transactions by a broker. This section also is not intended to apply to the audit of transactions arising from financial interests in partnerships, corporations, and joint ventures, such as working interests in oil and gas ventures, when proprietary interests are accounted for and reported to interest holders. [As amended, effective December 1999, by Statement on Auditing Standards No. 88. Revised, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

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[1] In this section, a service organization's controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements will be referred to as a service organization's *controls*.

.04 This section is organized into the following sections:

a. The user auditor's consideration of the effect of the service organization on the user organization's internal control and the availability of evidence to—

- Obtain the necessary understanding of the user organization's internal control to plan the audit
- Assess control risk at the user organization
- Perform substantive procedures

b. Considerations in using a service auditor's report

c. Responsibilities of service auditors

The User Auditor's Consideration of the Effect of the Service Organization on the User Organization's Internal Control and the Availability of Audit Evidence

.05 The user auditor should consider the discussion in paragraphs .06 through .21 when planning and performing the audit of an entity that uses a service organization to process its transactions.

The Effect of Use of a Service Organization on a User Organization's Internal Control

.06 When a user organization uses a service organization, transactions that affect the user organization's financial statements are subjected to controls that are, at least in part, physically and operationally separate from the user organization. The significance of the controls of the service organization to those of the user organization depends on the nature of the services provided by the service organization, primarily the nature and materiality of the transactions it processes for the user organization and the degree of interaction between its activities and those of the user organization. To illustrate how the degree of interaction affects user organization controls, when the user organization initiates transactions and the service organization executes and does the accounting processing of those transactions, there is a high degree of interaction between the activities at the user organization and those at the service organization. In these circumstances, it may be practicable for the user organization to implement effective controls for those transactions. However, when the service organization initiates, executes, and does the accounting processing of the user organization's transactions, there is a lower degree of interaction and it may not be practicable for the user organization to implement effective controls for those transactions. [As amended, effective December 1999, by Statement on Auditing Standards No. 88.]

Planning the Audit

.07 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, states that an auditor should obtain an understanding of each of the five components of the entity's internal control sufficient to plan the audit. This understanding may encompass controls placed in operation by the entity

and by service organizations whose services are part of the entity's information system. In planning the audit, such knowledge should be used to—

- Identify types of potential misstatements.
- Consider factors that affect the risk of material misstatement.
- Design tests of controls, when applicable. Paragraphs 65 through 69 of SAS No. 55 discuss factors the auditor considers in determining whether to perform tests of controls.
- Design substantive tests.

[.08] [Paragraph deleted by the issuance of Statement on Auditing Standards No. 88, December 1999.]

.09 Information about the nature of the services provided by a service organization that are part of the user organization's information system and the service organization's controls over those services may be available from a wide variety of sources, such as user manuals, system overviews, technical manuals, the contract between the user organization and the service organization, and reports by service auditors, internal auditors, or regulatory authorities on the service organization's controls. If the services and the service organization's controls over those services are highly standardized, information obtained through the user auditor's prior experience with the service organization may be helpful in planning the audit. [As amended, effective December 1999, by Statement on Auditing Standards No. 88.]

.10 After considering the available information, the user auditor may conclude that he or she has the means to obtain a sufficient understanding of internal control to plan the audit. If the user auditor concludes that information is not available to obtain a sufficient understanding to plan the audit, he or she may consider contacting the service organization, through the user organization, to obtain specific information or request that a service auditor be engaged to perform procedures that will supply the necessary information, or the user auditor may visit the service organization and perform such procedures. If the user auditor is unable to obtain sufficient evidence to achieve his or her audit objectives, the user auditor should qualify his or her opinion or disclaim an opinion on the financial statements because of a scope limitation. [As amended, effective December 1999, by Statement on Auditing Standards No. 88.]

Assessing Control Risk at the User Organization

.11 The user auditor uses his or her understanding of the internal control to assess control risk for the assertions embodied in the account balances and classes of transactions, including those that are affected by the activities of the service organization. In doing so, the user auditor may identify certain user organization controls that, if effective, would permit the user auditor to assess control risk below the maximum for particular assertions. Such controls may be applied at either the user organization or the service organization. The user auditor may conclude that it would be efficient to obtain evidential matter about the operating effectiveness of controls to provide a basis for assessing control risk below the maximum. [Revised, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

.12 A service auditor's report on controls placed in operation at the service organization should be helpful in providing a sufficient understanding to plan the audit of the user organization. Such a report, however, is not intended to provide any evidence of the operating effectiveness of the relevant controls that

would allow the user auditor to reduce the assessed level of control risk below the maximum. Such evidential matter should be derived from one or more of the following:

a. Tests of the user organization's controls over the activities of the service organization (for example, the user auditor may test the user organization's independent reperformance of selected items processed by a service organization or test the user organization's reconciliation of output reports with source documents)

b. A service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls

c. Appropriate tests of controls performed by the user auditor at the service organization

.13 The user organization may establish effective controls over the service organization's activities that may be tested and that may enable the user auditor to reduce the assessed level of control risk below the maximum for some or all of the related assertions. If a user organization, for example, uses a service organization to process its payroll transactions, the user organization may establish controls over the submission and receipt of payroll information that could prevent or detect material misstatements. The user organization might reperform the service organization's payroll calculations on a test basis. In this situation, the user auditor may perform tests of the user organization's controls over payroll processing that would provide a basis for assessing control risk below the maximum for the assertions related to payroll transactions. Alternatively, the user auditor may decide to assess control risk at the maximum level because he or she believes controls are unlikely to pertain to an assertion, are unlikely to be effective, or because he or she believes obtaining evidence about the operating effectiveness of the service organization's controls, such as those over changes in payroll programs, would not be efficient. [Revised, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

.14 The user auditor may find that controls relevant to assessing control risk below the maximum for particular assertions are applied only at the service organization. If the user auditor plans to assess control risk below the maximum for those assertions, he or she should evaluate the operating effectiveness of those controls by obtaining a service auditor's report that describes the results of the service auditor's tests of those controls (that is, a report on controls placed in operation and tests of operating effectiveness, or an agreed-upon procedures report)[2] or by performing tests of controls at the service organization. If the user auditor decides to use a service auditor's report, the user auditor should consider the extent of the evidence provided by the report about the effectiveness of controls intended to prevent or detect material misstatements in the particular assertions. The user auditor remains responsible for evaluating the evidence presented by the service auditor and for determining its effect on the assessment of control risk at the user organization.

.15 The user auditor's assessments of control risk regarding assertions about account balances or classes of transactions are based on the combined evidence provided by the service auditor's report and the user auditor's own procedures. In making these assessments, the user auditor should consider

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[2] See AT section 201, *Agreed-Upon Procedures Engagements*, for guidance on performing and reporting on agreed-upon procedures engagements. [Footnote added, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

the nature, source, and interrelationships among the evidence, as well as the period covered by the tests of controls. The user auditor uses the assessed levels of control risk, as well as his or her understanding of internal control, in determining the nature, timing, and extent of substantive tests for particular assertions.

.16 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The guidance in paragraph 18 and paragraphs 29 through 31 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, regarding the auditor's consideration of the sufficiency of evidential matter to support a specific assessed level of control risk is applicable to user auditors considering evidential matter provided by a service auditor's report on controls placed in operation and tests of operating effectiveness. Because the report may be intended to satisfy the needs of several different user auditors, a user auditor should determine whether the specific tests of controls and results in the service auditor's report are relevant to assertions that are significant in the user organization's financial statements. For those tests of controls and results that are relevant, a user auditor should consider whether the nature, timing, and extent of such tests of controls and results provide appropriate evidence about the effectiveness of the controls to support the user auditor's assessed level of control risk. In evaluating these factors, user auditors should also keep in mind that, for certain assumptions, the shorter the period covered by a specific test and the longer the time elapsed since the performance of the test, the less support for control risk reduction the test may provide. [Revised, May 2001, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

Audit Evidence From Substantive Audit Procedures Performed by Service Auditors

.17 Service auditors may be engaged to perform procedures that are substantive in nature for the benefit of user auditors. Such engagements may involve the performance, by the service auditor, of procedures agreed upon by the user organization and its auditor and by the service organization and its auditor. In addition, there may be requirements imposed by governmental authorities or through contractual arrangements whereby service auditors perform designated procedures that are substantive in nature. The results of the application of the required procedures to balances and transactions processed by the service organization may be used by user auditors as part of the evidence necessary to support their opinions.

Considerations in Using a Service Auditor's Report

.18 In considering whether the service auditor's report is satisfactory for his or her purposes, the user auditor should make inquiries concerning the service auditor's professional reputation. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in section 543, *Part of Audit Performed by Other Independent Auditors*, paragraph .10*a*.

.19 In considering whether the service auditor's report is sufficient to meet his or her objectives, the user auditor should give consideration to the guidance in section 543.12. If the user auditor believes that the service auditor's report may not be sufficient to meet his or her objectives, the user auditor may

supplement his or her understanding of the service auditor's procedures and conclusions by discussing with the service auditor the scope and results of the service auditor's work. Also, if the user auditor believes it is necessary, he or she may contact the service organization, through the user organization, to request that the service auditor perform agreed-upon procedures at the service organization, or the user auditor may perform such procedures.

.20 *[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2004, for accelerated filers, and on or after July 15, 2005, for all other issuers. See PCAOB Release No. 2004-008.]*

When assessing a service organization's controls and how they interact with a user organization's controls, the user auditor may become aware of the existence of significant deficiencies. In such circumstances, the user auditor should consider the guidance provided in section 325, *Communications About Control Deficiencies in An Audit of Financial Statements*.

.21 The user auditor should not make reference to the report of the service auditor as a basis, in part, for his or her own opinion on the user organization's financial statements. The service auditor's report is used in the audit, but the service auditor is not responsible for examining any portion of the financial statements as of any specific date or for any specified period. Thus, there cannot be a division of responsibility for the audit of the financial statements.

Responsibilities of Service Auditors

.22 The service auditor is responsible for the representations in his or her report and for exercising due care in the application of procedures that support those representations. Although a service auditor's engagement differs from an audit of financial statements conducted in accordance with generally accepted auditing standards, it should be performed in accordance with the general standards and with the relevant fieldwork and reporting standards. Although the service auditor should be independent from the service organization, it is not necessary for the service auditor to be independent from each user organization.

.23 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

As a result of procedures performed at the service organization, the service auditor may become aware of illegal acts, fraud, or uncorrected errors attributable to the service organization's management or employees that may affect one or more user organizations. The terms *errors*, *fraud*, and *illegal acts* are discussed in Auditing Standard No. 14, *Evaluating Audit Results*, and section 317, *Illegal Acts by Clients*; the discussions therein are relevant to this section. When the service auditor becomes aware of such matters, he or she should determine from the appropriate level of management of the service organization whether this information has been communicated appropriately to affected user organizations, unless those matters are clearly inconsequential. If the management of the service organization has not communicated the information to affected user organizations and is unwilling to do so, the service auditor should inform the service organization's audit committee or others with equivalent authority or responsibility. If the audit committee does not respond appropriately to the service auditor's communication, the service auditor should consider whether to resign from the engagement. The service auditor may wish to consult with his or her attorney in making this decision.

.24 The type of engagement to be performed and the related report to be prepared should be established by the service organization. However, when circumstances permit, discussions between the service organization and the

user organizations are advisable to determine the type of report that will be most suitable for the user organizations' needs. This section provides guidance on the two types of reports that may be issued:

a. *Reports on controls placed in operation*—A service auditor's report on a service organization's description of the controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, on whether such controls were suitably designed to achieve specified control objectives, and on whether they had been placed in operation as of a specific date. Such reports may be useful in providing a user auditor with an understanding of the controls necessary to plan the audit and to design effective tests of controls and substantive tests at the user organization, but they are not intended to provide the user auditor with a basis for reducing his or her assessments of control risk below the maximum.

b. *Reports on controls placed in operation and tests of operating effectiveness*—A service auditor's report on a service organization's description of the controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, on whether such controls were suitably designed to achieve specified control objectives, on whether they had been placed in operation as of a specific date, and on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified. Such reports may be useful in providing the user auditor with an understanding of the controls necessary to plan the audit and may also provide the user auditor with a basis for reducing his or her assessments of control risk below the maximum.

Reports on Controls Placed in Operation

.25 The information necessary for a report on controls placed in operation ordinarily is obtained through discussions with appropriate service organization personnel and through reference to various forms of documentation, such as system flowcharts and narratives.

.26 After obtaining a description of the relevant controls, the service auditor should determine whether the description provides sufficient information for user auditors to obtain an understanding of those aspects of the service organization's controls that may be relevant to a user organization's internal control. The description should contain a discussion of the features of the service organization's controls that would have an effect on a user organization's internal control. Such features are relevant when they directly affect the service provided to the user organization. They may include controls within the control environment, risk assessment, control activities, information and communication, and monitoring components of internal control. The control environment may include hiring practices and key areas of authority and responsibility. Risk assessment may include the identification of risks associated with processing specific transactions. Control activities may include policies and procedures over the modification of computer programs and are ordinarily designed to meet specific control objectives. The specific control objectives of the service organization should be set forth in the service organization's description of controls. Information and communication may include ways in which user transactions are initiated and processed. Monitoring may include the involvement of internal

auditors. [As amended, effective for service auditor's reports covering descriptions as of or after January 1, 1997, by Statement on Auditing Standards No. 78.]

.27 Evidence of whether controls have been placed in operation is ordinarily obtained through previous experience with the service organization and through procedures such as inquiry of appropriate management, supervisory, and staff personnel; inspection of service organization documents and records; and observation of service organization activities and operations. For the type of report described in paragraph .24*a*, these procedures need not be supplemented by tests of the operating effectiveness of the service organization's controls.

.28 Although a service auditor's report on controls placed in operation is as of a specified date, the service auditor should inquire about changes in the service organization's controls that may have occurred before the beginning of fieldwork. If the service auditor believes that the changes would be considered significant by user organizations and their auditors, those changes should be included in the description of the service organization's controls. If the service auditor concludes that the changes would be considered significant by user organization's and their auditors and the changes are not included in the description of the service organization's controls, the service auditor should describe the changes in his or her report. Such changes might include—

- Procedural changes made to accommodate provisions of a new FASB Statement of Financial Accounting Standards.
- Major changes in an application to permit on-line processing.
- Procedural changes to eliminate previously identified deficiencies.

Changes that occurred more than twelve months before the date being reported on normally would not be considered significant, because they generally would not affect user auditors' considerations.

.29 A service auditor's report expressing an opinion on a description of controls placed in operation at a service organization should contain—

a. A specific reference to the applications, services, products, or other aspects of the service organization covered.

b. A description of the scope and nature of the service auditor's procedures.

c. Identification of the party specifying the control objectives.

d. An indication that the purpose of the service auditor's engagement was to obtain reasonable assurance about whether (1) the service organization's description presents fairly, in all material respects, the aspects of the service organization's controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, (2) the controls were suitably designed to achieve specified control objectives, and (3) such controls had been placed in operation as of a specific date.

e. A disclaimer of opinion on the operating effectiveness of the controls.

f. The service auditor's opinion on whether the description presents fairly, in all material respects, the relevant aspects of the service organization's controls that had been placed in operation as of a specific date and whether, in the service auditor's opinion, the controls were suitably designed to provide reasonable assurance that the specified control objectives would be achieved if those controls were complied with satisfactorily.

g. A statement of the inherent limitations of the potential effectiveness of controls at the service organization and of the risk of projecting to future periods any evaluation of the description.

h. Identification of the parties for whom the report is intended.

.30 If the service auditor believes that the description is inaccurate or insufficiently complete for user auditors, the service auditor's report should so state and should contain sufficient detail to provide user auditors with an appropriate understanding.

.31 It may become evident to the service auditor, when considering the service organization's description of controls placed in operation, that the system was designed with the assumption that certain controls would be implemented by the user organization. If the service auditor is aware of the need for such complementary user organization controls, these should be delineated in the description of controls. If the application of controls by user organizations is necessary to achieve the stated control objectives, the service auditor's report should be modified to include the phrase "and user organizations applied the controls contemplated in the design of the Service Organization's controls" following the words "complied with satisfactorily" in the scope and opinion paragraphs.

.32 The service auditor should consider conditions that come to his or her attention that, in the service auditor's judgment, represent significant deficiencies in the design or operation of the service organization's controls that preclude the service auditor from obtaining reasonable assurance that specified control objectives would be achieved. The service auditor should also consider whether any other information, irrespective of specified control objectives, has come to his or her attention that causes him or her to conclude (*a*) that design deficiencies exist that could adversely affect the ability to initiate, record, process, or report financial data to user organizations without error, and (*b*) that user organizations would not generally be expected to have controls in place to mitigate such design deficiencies. [Revised, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

.33 The description of controls and control objectives required for these reports may be prepared by the service organization. If the service auditor prepares the description of controls and control objectives, the representations in the description remain the responsibility of the service organization.

.34 For the service auditor to express an opinion on whether the controls were suitably designed to achieve the specified control objectives, it is necessary that—

a. The service organization identify and appropriately describe such control objectives and the relevant controls.

b. The service auditor consider the linkage of the controls to the stated control objectives.

c. The service auditor obtain sufficient evidence to reach an opinion.

.35 The control objectives may be designated by the service organization or by outside parties such as regulatory authorities, a user group, or others. When the control objectives are not established by outside parties, the service auditor should be satisfied that the control objectives, as set forth by the service organization, are reasonable in the circumstances and consistent with the service organization's contractual obligations.

.36 The service auditor's report should state whether the controls were suitably designed to achieve the specified control objectives. The report should

not state whether they were suitably designed to achieve objectives beyond the specifically identified control objectives.

.37 The service auditor's opinion on whether the controls were suitably designed to achieve the specified control objectives is not intended to provide evidence of operating effectiveness or to provide the user auditor with a basis for concluding that control risk may be assessed below the maximum.

.38 The following is a sample report on controls placed in operation at a service organization. The report should have, as an attachment, a description of the service organization's controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements. This report is illustrative only and should be modified as appropriate to suit the circumstances of individual engagements.

To XYZ Service Organization:

We have examined the accompanying description of controls related to the __ application of XYZ Service Organization. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Service Organization's controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, (2) the controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily,[3] and (3) such controls had been placed in operation as of ____. The control objectives were specified by ___. Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

We did not perform procedures to determine the operating effectiveness of controls for any period. Accordingly, we express no opinion on the operating effectiveness of any aspects of XYZ Service Organization's controls, individually or in the aggregate.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's controls that had been placed in operation as of ___. Also, in our opinion, the controls, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily.

The description of controls at XYZ Service Organization is as of ____ and any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the controls in existence. The potential effectiveness of specific controls at the Service Organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers ___.

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[3] If the application of controls by user organizations is necessary to achieve the stated control objectives, the service auditor's report should be modified to include the phrase "and user organizations applied the controls contemplated in the design of XYZ Service Organization's controls" following the words "complied with satisfactorily" in the scope and opinion paragraphs. [Footnote renumbered, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

.39 If the service auditor concludes that the description is inaccurate or insufficiently complete for user auditors, the service auditor should so state in an explanatory paragraph preceding the opinion paragraph. An example of such an explanatory paragraph follows:

> The accompanying description states that XYZ Service Organization uses operator identification numbers and passwords to prevent unauthorized access to the system. Based on inquiries of staff personnel and inspections of activities, we determined that such procedures are employed in Applications A and B but are not required to access the system in Applications C and D.

In addition, the first sentence of the opinion paragraph would be modified to read as follows:

> In our opinion, except for the matter referred to in the preceding paragraph, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's controls that had been placed in operation as of ____.

.40 If, after applying the criteria in paragraph .32, the service auditor concludes that there are significant deficiencies in the design or operation of the service organization's controls, the service auditor should report those conditions in an explanatory paragraph preceding the opinion paragraph. An example of an explanatory paragraph describing a significant deficiency in the design or operation of the service organization's controls follows:

> As discussed in the accompanying description, from time to time the Service Organization makes changes in application programs to correct deficiencies or to enhance capabilities. The procedures followed in determining whether to make changes, in designing the changes, and in implementing them do not include review and approval by authorized individuals who are independent from those involved in making the changes. There are also no specified requirements to test such changes or provide test results to an authorized reviewer prior to implementing the changes.

In addition, the second sentence of the opinion paragraph would be modified to read as follows:

> Also in our opinion, except for the deficiency referred to in the preceding paragraph, the controls, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily.

Reports on Controls Placed in Operation and Tests of Operating Effectiveness

Paragraphs .41 through .56 repeat some of the information contained in paragraphs .25 through .40 to provide readers with a comprehensive, stand-alone presentation of the relevant considerations for each type of report.

.41 The information necessary for a report on controls placed in operation and tests of operating effectiveness ordinarily is obtained through discussions with appropriate service organization personnel, through reference to various forms of documentation, such as system flowcharts and narratives, and through the performance of tests of controls. Evidence of whether controls have been placed in operation is ordinarily obtained through previous experience with the service organization and through procedures such as inquiry of appropriate management, supervisory, and staff personnel; inspection of service organization documents and records; and observation of service organization activities and operations. The service auditor applies tests of controls to

determine whether specific controls are operating with sufficient effectiveness to achieve specified control objectives. Section 350, *Audit Sampling*, provides guidance on the application and evaluation of audit sampling in performing tests of controls.

.42 After obtaining a description of the relevant controls, the service auditor should determine whether the description provides sufficient information for user auditors to obtain an understanding of those aspects of the service organization's controls that may be relevant to a user organization's internal control. The description should contain a discussion of the features of the service organization's controls that would have an effect on a user organization's internal control. Such features are relevant when they directly affect the service provided to the user organization. They may include controls within the control environment, risk assessment, control activities, information and communication, and monitoring components of internal control. The control environment may include hiring practices and key areas of authority and responsibility. Risk assessment may include the identification of risks associated with processing specific transactions. Control activities may include policies and procedures over the modification of computer programs and are ordinarily designed to meet specific control objectives. The specific control objectives of the service organization should be set forth in the service organization's description of controls. Information and communication may include ways in which user transactions are initiated and processed. Monitoring may include the involvement of internal auditors. [As amended, effective for service auditor's reports covering descriptions as of or after January 1, 1997, by Statement on Auditing Standards No. 78.]

.43 The service auditor should inquire about changes in the service organization's controls that may have occurred before the beginning of fieldwork. If the service auditor believes the changes would be considered significant by user organizations and their auditors, those changes should be included in the description of the service organization's controls. If the service auditor concludes that the changes would be considered significant by user organizations and their auditors and the changes are not included in the description of the service organization's controls, the service auditor should describe the changes in his or her report. Such changes might include—

- Procedural changes made to accommodate provisions of a new FASB Statement of Financial Accounting Standards.
- Major changes in an application to permit on-line processing.
- Procedural changes to eliminate previously identified deficiencies.

Changes that occurred more than twelve months before the date being reported on normally would not be considered significant, because they generally would not affect user auditors' considerations.

.44 A service auditor's report expressing an opinion on a description of controls placed in operation at a service organization and tests of operating effectiveness should contain—

a. A specific reference to the applications, services, products, or other aspects of the service organization covered.

b. A description of the scope and nature of the service auditor's procedures.

c. Identification of the party specifying the control objectives.

d. An indication that the purpose of the service auditor's engagement was to obtain reasonable assurance about whether (1) the service organization's description presents fairly, in all material respects, the aspects of the service organization's controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, (2) the controls were suitably designed to achieve specified control objectives, and (3) such controls had been placed in operation as of a specific date.

e. The service auditor's opinion on whether the description presents fairly, in all material respects, the relevant aspects of the service organization's controls that had been placed in operation as of a specific date and whether, in the service auditor's opinion, the controls were suitably designed to provide reasonable assurance that the specified control objectives would be achieved if those controls were complied with satisfactorily.

f. A reference to a description of tests of specific service organization controls designed to obtain evidence about the operating effectiveness of those controls in achieving specified control objectives. The description should include the controls that were tested, the control objectives the controls were intended to achieve, the tests applied, and the results of the tests. The description should include an indication of the nature, timing, and extent of the tests, as well as sufficient detail to enable user auditors to determine the effect of such tests on user auditors' assessments of control risk. To the extent that the service auditor identified causative factors for exceptions, determined the current status of corrective actions, or obtained other relevant qualitative information about exceptions noted, such information should be provided.

g. A statement of the period covered by the service auditor's report on the operating effectiveness of the specific controls tested.

h. The service auditor's opinion on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

i. When all of the control objectives listed in the description of controls placed in operation are not covered by tests of operating effectiveness, a statement that the service auditor does not express an opinion on control objectives not listed in the description of tests performed at the service organization.

j. A statement that the relative effectiveness and significance of specific service organization controls and their effect on assessments of control risk at user organizations are dependent on their interaction with the controls and other factors present at individual user organizations.

k. A statement that the service auditor has performed no procedures to evaluate the effectiveness of controls at individual user organizations.

l. A statement of the inherent limitations of the potential effectiveness of controls at the service organization and of the risk of projecting to the future any evaluation of the description or any conclusions about the effectiveness of controls in achieving control objectives.

m. Identification of the parties for whom the report is intended.

.45 If the service auditor believes that the description is inaccurate or insufficiently complete for user auditors, the service auditor's report should so state and should contain sufficient detail to provide user auditors with an appropriate understanding.

.46 It may become evident to the service auditor, when considering the service organization's description of controls placed in operation, that the system was designed with the assumption that certain controls would be implemented by the user organization. If the service auditor is aware of the need for such complementary user organization controls, these should be delineated in the description of controls. If the application of controls by user organizations is necessary to achieve the stated control objectives, the service auditor's report should be modified to include the phrase "and user organizations applied the controls contemplated in the design of the Service Organization's controls" following the words "complied with satisfactorily" in the scope and opinion paragraphs. Similarly, if the operating effectiveness of controls at the service organization is dependent on the application of controls at user organizations, this should be delineated in the description of tests performed.

.47 The service auditor should consider conditions that come to his or her attention that, in the service auditor's judgment, represent significant deficiencies in the design or operation of the service organization's controls that preclude the service auditor from obtaining reasonable assurance that specified control objectives would be achieved. The service auditor should also consider whether any other information, irrespective of specified control objectives, has come to his or her attention that causes him or her to conclude (*a*) that design deficiencies exist that could adversely affect the ability to initiate, record, process, or report financial data to user organizations without error, and (*b*) that user organizations would not generally be expected to have controls in place to mitigate such design deficiencies. [Revised, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

.48 The description of controls and control objectives required for these reports may be prepared by the service organization. If the service auditor prepares the description of controls and control objectives, the representations in the description remain the responsibility of the service organization.

.49 For the service auditor to express an opinion on whether the controls were suitably designed to achieve the specified control objectives, it is necessary that—

a. The service organization identify and appropriately describe such control objectives and the relevant controls.

b. The service auditor consider the linkage of the controls to the stated control objectives.

c. The service auditor obtain sufficient evidence to reach an opinion.

.50 The control objectives may be designated by the service organization or by outside parties such as regulatory authorities, a user group, or others. When the control objectives are not established by outside parties, the service auditor should be satisfied that the control objectives, as set forth by the service organization, are reasonable in the circumstances and consistent with the service organization's contractual obligations.

.51 The service auditor's report should state whether the controls were suitably designed to achieve the specified control objectives. The report should not state whether they were suitably designed to achieve objectives beyond the specifically identified control objectives.

.52 The service auditor's opinion on whether the controls were suitably designed to achieve the specified control objectives is not intended to provide evidence of operating effectiveness or to provide the user auditor with a basis for concluding that control risk may be assessed below the maximum. Evidence that may enable the user auditor to conclude that control risk may be assessed below the maximum may be obtained from the results of specific tests of operating effectiveness.

.53 The management of the service organization specifies whether all or selected applications and control objectives will be covered by the tests of operating effectiveness. The service auditor determines which controls are, in his or her judgment, necessary to achieve the control objectives specified by management. The service auditor then determines the nature, timing, and extent of the tests of controls needed to evaluate operating effectiveness. Testing should be applied to controls in effect throughout the period covered by the report. To be useful to user auditors, the report should ordinarily cover a minimum reporting period of six months.

.54 The following is a sample report on controls placed in operation at a service organization and tests of operating effectiveness. It should be assumed that the report has two attachments: (*a*) a description of the service organization's controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements and (*b*) a description of controls for which tests of operating effectiveness were performed, the control objectives the controls were intended to achieve, the tests applied, and the results of those tests. This report is illustrative only and should be modified as appropriate to suit the circumstances of individual engagements.

To XYZ Service Organization:

We have examined the accompanying description of controls related to the __ application of XYZ Service Organization. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Service Organization's controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, (2) the controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily,[4] and (3) such controls had been placed in operation as of ____. The control objectives were specified by ___. Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's controls that had been placed in operation as of ___. Also, in our opinion, the controls, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily.

In addition to the procedures we considered necessary to render our opinion as expressed in the previous paragraph, we applied tests to specific controls,

[4] If the application of controls by user organizations is necessary to achieve the stated control objectives, the service auditor's report should be modified to include the phrase "and user organizations applied the controls contemplated in the design of XYZ Service Organization's controls" following the words "complied with satisfactorily" in the scope and opinion paragraphs. [Footnote renumbered, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

listed in Schedule X, to obtain evidence about their effectiveness in meeting the control objectives, described in Schedule X, during the period from ___ to ___. The specific controls and the nature, timing, extent, and results of the tests are listed in Schedule X. This information has been provided to user organizations of XYZ Service Organization and to their auditors to be taken into consideration, along with information about the internal control at user organizations, when making assessments of control risk for user organizations. In our opinion the controls that were tested, as described in Schedule X, were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives specified in Schedule X were achieved during the period from ___ to ___. [However, the scope of our engagement did not include tests to determine whether control objectives not listed in Schedule X were achieved; accordingly, we express no opinion on the achievement of control objectives not included in Schedule X.][5]

The relative effectiveness and significance of specific controls at XYZ Service Organization and their effect on assessments of control risk at user organizations are dependent on their interaction with the controls and other factors present at individual user organizations. We have performed no procedures to evaluate the effectiveness of controls at individual user organizations.

The description of controls at XYZ Service Organization is as of _____, and information about tests of the operating effectiveness of specific controls covers the period from ____ to ____. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the controls in existence. The potential effectiveness of specific controls at the Service Organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers.

.55 If the service auditor concludes that the description is inaccurate or insufficiently complete for user auditors, the service auditor should so state in an explanatory paragraph preceding the opinion paragraph. An example of such an explanatory paragraph follows:

The accompanying description states that XYZ Service Organization uses operator identification numbers and passwords to prevent unauthorized access to the system. Based on inquiries of staff personnel and inspection of activities, we determined that such procedures are employed in Applications A and B but are not required to access the system in Applications C and D.

In addition, the first sentence of the opinion paragraph would be modified to read as follows:

In our opinion, except for the matter referred to in the preceding paragraph, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's controls that had been placed in operation as of ___.

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[5] This sentence should be added when all of the control objectives listed in the description of controls placed in operation are not covered by the tests of operating effectiveness. This sentence would be omitted when all of the control objectives listed in the description of controls placed in operation are included in the tests of operating effectiveness. [Footnote renumbered, April 2002, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

.56 If, after applying the criteria in paragraph .47, the service auditor concludes that there are significant deficiencies in the design or operation of the service organization's controls, the service auditor should report those conditions in an explanatory paragraph preceding the opinion paragraph. An example of an explanatory paragraph describing a significant deficiency in the design or operation of the service organization's controls follows:

> As discussed in the accompanying description, from time to time the Service Organization makes changes in application programs to correct deficiencies or to enhance capabilities. The procedures followed in determining whether to make changes, in designing the changes, and in implementing them do not include review and approval by authorized individuals who are independent from those involved in making the changes. There are also no specified requirements to test such changes or provide test results to an authorized reviewer prior to implementing the changes.

In addition, the second sentence of the opinion paragraph would be modified to read as follows:

> Also in our opinion, except for the deficiency referred to in the preceding paragraph, the controls, as described, are suitably designed to provide reasonable assurance that the related control objectives would be achieved if the described controls were complied with satisfactorily.

Responsibilities of Service Organizations and Service Auditors With Respect to Subsequent Events

.57 Changes in a service organization's controls that could affect user organizations' information systems may occur subsequent to the period covered by the service auditor's report but before the date of the service auditor's report. These occurrences are referred to as subsequent events. A service auditor should consider information about two types of subsequent events that come to his or her attention. [Paragraph added, effective for reports issued on or after January 1, 2003, by Statement on Auditing Standards No. 98.]

.58 The first type consists of events that provide additional information about conditions that existed during the period covered by the service auditor's report. This information should be used by the service auditor in determining whether controls at the service organization that could affect user organizations' information systems were placed in operation, suitably designed, and, if applicable, operating effectively during the period covered by the engagement. [Paragraph added, effective for reports issued on or after January 1, 2003, by Statement on Auditing Standards No. 98.]

.59 The second type consists of those events that provide information about conditions that arose subsequent to the period covered by the service auditor's report that are of such a nature and significance that their disclosure is necessary to prevent users from being misled. This type of information ordinarily will not affect the service auditor's report if the information is adequately disclosed by management in a section of the report containing "Other Information Provided by the Service Organization." If this information is not disclosed by the service organization, the service auditor should disclose it in a section of the report containing "Other Information Provided by the Service Auditor" and/or in the service auditor's report. [Paragraph added, effective for reports issued on or after January 1, 2003, by Statement on Auditing Standards No. 98.]

.60 Although a service auditor has no responsibility to detect subsequent events, the service auditor should inquire of management as to whether it is

aware of any subsequent events through the date of the service auditor's report that would have a significant effect on user organizations. In addition, a service auditor should obtain a representation from management regarding subsequent events. [Paragraph added, effective for reports issued on or after January 1, 2003, by Statement on Auditing Standards No. 98.]

Written Representations of the Service Organization's Management

.61 Regardless of the type of report issued, the service auditor should obtain written representations from the service organization's management that—

- Acknowledge management's responsibility for establishing and maintaining appropriate controls relating to the processing of transactions for user organizations.
- Acknowledge the appropriateness of the specified control objectives.
- State that the description of controls presents fairly, in all material respects, the aspects of the service organization's controls that may be relevant to a user organization's internal control.
- State that the controls, as described, had been placed in operation as of a specific date.
- State that management believes its controls were suitably designed to achieve the specified control objectives.
- State that management has disclosed to the service auditor any significant changes in controls that have occurred since the service organization's last examination.
- State that management has disclosed to the service auditor any illegal acts, fraud, or uncorrected errors attributable to the service organization's management or employees that may affect one or more user organizations.
- State that management has disclosed to the service auditor all design deficiencies in controls of which it is aware, including those for which management believes the cost of corrective action may exceed the benefits.
- State that management has disclosed to the service auditor any subsequent events that would have a significant effect on user organizations.

If the scope of the work includes tests of operating effectiveness, the service auditor should obtain a written representation from the service organization's management stating that management has disclosed to the service auditor all instances, of which it is aware, when controls have not operated with sufficient effectiveness to achieve the specified control objectives. [Paragraph renumbered and amended, effective for reports issued on or after January 1, 2003, by Statement on Auditing Standards No. 98.]

Reporting on Substantive Procedures

.62 The service auditor may be requested to apply substantive procedures to user transactions or assets at the service organization. In such circumstances, the service auditor may make specific reference in his or her report to having

carried out the designated procedures or may provide a separate report in accordance with AT section 201, *Agreed-Upon Procedures Engagements*. Either form of reporting should include a description of the nature, timing, extent, and results of the procedures in sufficient detail to be useful to user auditors in deciding whether to use the results as evidence to support their opinions. [Revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10. Paragraph renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

Effective Date

.63 This section is effective for service auditors' reports dated after March 31, 1993. Earlier application of this section is encouraged. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

AU Section 9324

Service Organizations: Auditing Interpretations of Section 324

1. Describing Tests of Operating Effectiveness and the Results of Such Tests

.01 *Question*—Paragraph .44*f* of section 324, *Service Organizations*, specifies the elements that should be included in a description of tests of operating effectiveness, which is part of a report on controls placed in operation and tests of operating effectiveness. Section 324.44*f* states:

> "...The description should include the controls that were tested, the control objectives the controls were intended to achieve, the tests applied and the results of the tests. The description should include an indication of the nature, timing, and extent of the tests, as well as sufficient detail to enable user auditors to determine the effect of such tests on user auditors' assessments of control risk. To the extent that the service auditor identified causative factors for exceptions, determined the current status of corrective actions, or obtained other relevant qualitative information about exceptions noted, such information should be provided."

When a service auditor performs an engagement that includes tests of operating effectiveness, what information and how much detail should be included in the description of the "tests applied" and the "results of the tests"?

.02 *Interpretation*—In all cases, for each control objective tested, the description of tests of operating effectiveness should include all of the elements listed in section 324.44*f*, whether or not the service auditor concludes that the control objective has been achieved. The description should provide sufficient information to enable user auditors to assess control risk for financial statement assertions affected by the service organization. The description need not be a duplication of the service auditor's detailed audit program, which in some cases would make the report too voluminous for user auditors and would provide more than the required level of detail.

.03 In describing the nature, timing, and extent of the tests applied, the service auditor also should indicate whether the items tested represent a sample or all of the items in the population, but need not indicate the size of the population. In describing the results of the tests, the service auditor should include exceptions and other information that in the service auditor's judgment could be relevant to user auditors. Such exceptions and other information should be included for each control objective, whether or not the service auditor concludes that the control objective has been achieved. When exceptions that could be relevant to user auditors are noted, the description also should include the following information:

- The size of the sample, when sampling has been used
- The number of exceptions noted
- The nature of the exceptions

If no exceptions or other information that could be relevant to user auditors are identified by the tests, the service auditor should indicate that finding (for example, "No relevant exceptions noted").

[Issue Date: April, 1995.]

2. Service Organizations That Use the Services of Other Service Organizations (Subservice Organizations)

.04 *Question*—A service organization may use the services of another service organization, such as a bank trust department that uses an independent computer processing service organization to perform its data processing. In this situation, the bank trust department is a service organization and the computer processing service organization is considered a subservice organization. How are a user auditor's and a service auditor's procedures affected when a service organization uses a subservice organization?

.05 *Interpretation*—When a service organization uses a subservice organization, the user auditor should determine whether the processing performed by the subservice organization affects assertions in the user organization's financial statements and whether those assertions are significant to the user organization's financial statements. To plan the audit and assess control risk, a user auditor may need to consider the controls at both the service organization and the subservice organization. Paragraphs .06 through .17 of section 324, *Service Organizations*, provide guidance to user auditors on considering the effect of a service organization on a user organization's internal control. Although section 324.06-.17 do not specifically refer to subservice organizations, when a subservice organization provides services to a service organization, the guidance in these paragraphs should be interpreted to include the subservice organization. For example, in situations where subservice organizations are used, the interaction between the user organization and the service organization described in section 324.06 would be expanded to include the interaction between the user organization, the service organization and the subservice organization.

.06 Similarly, a service auditor engaged to examine the controls of a service organization and issue a service auditor's report may need to consider functions performed by the subservice organization and the effect of the subservice organization's controls on the service organization.

.07 The degree of interaction and the nature and materiality of the transactions processed by the service organization and the subservice organization are the most important factors to consider in determining the significance of the subservice organization's controls to the user organization's internal control. Section 324.11–.16 describe how a user auditor's assessment of control risk is affected when a user organization uses a service organization. When a subservice organization is involved, the user auditor may need to consider activities at both the service organization and the subservice organization in applying the guidance in these paragraphs.

.08 *Question*—How does a user auditor obtain information about controls at a subservice organization?

.09 *Interpretation*—If a user auditor concludes that he or she needs information about the subservice organization to plan the audit or to assess control risk, the user auditor (*a*) may contact the service organization through the user organization and may contact the subservice organization either through the user organization or the service organization to obtain specific information or (*b*) may request that a service auditor be engaged to perform procedures that will supply the necessary information. Alternatively, the user auditor may visit the service organization or subservice organization and perform such procedures.

.10 *Question*—When a service organization uses a subservice organization, what information about the subservice organization should be included in the service organization's description of controls?

.11 *Interpretation*—A service organization's description of controls should include a description of the functions and nature of the processing performed by the subservice organization in sufficient detail for user auditors to understand the significance of the subservice organization's functions to the processing of the user organizations' transactions. Ordinarily, disclosure of the identity of the subservice organization is not required. However, if the service organization determines that the identity of the subservice organization would be relevant to user organizations, the name of the subservice organization may be included in the description. The purpose of the description of the functions and nature of the processing performed by the subservice organization is to alert user organizations and their auditors to the fact that another entity (that is, the subservice organization) is involved in the processing of the user organizations' transactions and to summarize the functions the subservice organization performs.

.12 When a subservice organization performs services for a service organization, there are two alternative methods of presenting the description of controls. The service organization determines which method will be used.

a. *The Carve-Out Method*—The subservice organization's relevant control objectives and controls are excluded from the description and from the scope of the service auditor's engagement. The service organization states in the description that the subservice organization's control objectives and related controls are omitted from the description and that the control objectives in the report include only the objectives the service organization's controls are intended to achieve.

b. *The Inclusive Method*—The subservice organization's relevant controls are included in the description and in the scope of the engagement. The description should clearly differentiate between controls of the service organization and controls of the subservice organization. The set of control objectives includes all of the objectives a user auditor would expect both the service organization and the subservice organization to achieve. To accomplish this, the service organization should coordinate the preparation and presentation of the description of controls with the subservice organization.

In either method, the service organization includes in its description of controls a description of the functions and nature of the processing performed by the subservice organization, as set forth in paragraph .11.

.13 If the functions and processing performed by the subservice organization are significant to the processing of user organization transactions, and the service organization does not disclose the existence of the subservice organization and the functions it performs, the service auditor may need to issue a qualified or adverse opinion as to the fairness of the presentation of the description of controls.

.14 *Question*—How is the service auditor's report affected by the method of presentation selected?

.15 *Interpretation*—If the service organization has adopted the carve-out method, the service auditor should modify the scope paragraph of the service auditor's report to briefly summarize the functions and nature of the processing performed by the subservice organization. This summary ordinarily would be

briefer than the information provided by the service organization in its description of the functions and nature of the processing performed by the subservice organization. The service auditor should include a statement in the scope paragraph of the service auditor's report indicating that the description of controls includes only the control objectives and related controls of the service organization; accordingly, the service auditor's examination does not extend to controls at the subservice organization.

.16 An example of the scope paragraph of a service auditor's report using the carve-out method is presented below. Additional or modified report language is shown in ***boldface italics***.

Sample Scope Paragraph of a Service Auditor's Report Using the Carve-Out Method

Independent Service Auditor's Report

To the Board of Directors of Example Trust Company:

We have examined the accompanying description of the controls of Example Trust Company applicable to the processing of transactions for users of the Institutional Trust Division. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of Example Trust Company's controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements; (2) the controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily, and user organizations applied the controls contemplated in the design of Example Trust Company's controls; and (3) such controls had been placed in operation as of June 30, 20XX. ***Example Trust Company uses a computer processing service organization for all of its computerized application processing. The accompanying description includes only those control objectives and related controls of Example Trust Company and does not include control objectives and related controls of the computer processing service organization. Our examination did not extend to controls of the computer processing service organization.*** The control objectives were specified by the management of Example Trust Company. Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

[The remainder of the report is the same as the standard service auditor's report illustrated in section 324.38 and .54.]

.17 If the service organization has used the inclusive method, the service auditor should perform procedures comparable to those described in section 324.12. Such procedures may include performing tests of the service organization's controls over the activities of the subservice organization or performing procedures at the subservice organization. If the service auditor will be performing procedures at the subservice organization, the service organization should arrange for such procedures. The service auditor should recognize that the subservice organization generally is not the client for the engagement. Accordingly, in these circumstances the service auditor should determine whether it will be possible to obtain the required evidence to support the portion of the opinion covering the subservice organization and whether it will be possible to obtain an appropriate letter of representations regarding the subservice organization's controls.

.18 An example of a service auditor's report using the inclusive method is presented below. Additional or modified report language is shown in ***boldface italics***.

Sample Service Auditor's Report Using the Inclusive Method

Independent Service Auditor's Report

To the Board of Directors of Example Trust Company:

We have examined the accompanying description of the controls of Example Trust Company ***and Computer Processing Service Organization, an independent service organization that provides computer processing services to Example Trust Company,*** applicable to the processing of transactions for users of the Institutional Trust Division. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of Example Trust Company's ***and Computer Processing Service Organization's*** controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements; (2) the controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily, and user organizations applied the controls contemplated in the design of Example Trust Company's controls; and (3) the controls had been placed in operation as of June 30, 20XX. The control objectives were specified by the management of Example Trust Company. Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

In our opinion, the accompanying description of the aforementioned controls presents fairly, in all material respects, the relevant aspects of Example Trust Company's ***and Computer Processing Service Organization's*** controls that had been placed in operation as of June 30, 20XX. Also, in our opinion, the controls, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily and user organizations applied the controls contemplated in the design of Example Trust Company's controls.

In addition to the procedures we considered necessary to render our opinion as expressed in the previous paragraph, we applied tests to specific controls, listed in Schedule X to obtain evidence about their effectiveness in meeting the control objectives, described in Schedule X, during the period from January 1, 20XX, to June 30, 20XX. The specific controls and the nature, timing, extent, and results of the tests are listed in Schedule X. This information has been provided to user organizations of Example Trust Company and to their auditors to be taken into consideration, along with information about internal control at user organizations, when making assessments of control risk for user organizations. In our opinion the controls that were tested, as described in Schedule X, were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives specified in Schedule X were achieved during the period from January 1, 20XX, to June 30, 20XX.

The relative effectiveness and significance of specific controls at Example Trust Company ***and Computer Processing Service Organization***, and their effect on assessments of control risk at user organizations are dependent on their interaction with the controls and other factors present at individual user organizations. We have performed no procedures to evaluate the effectiveness of controls at individual user organizations.

The description of controls at Example Trust Company ***and Computer Processing Service Organization*** is as of June 30, 20XX, and information about tests of the operating effectiveness of specific controls covers the period from January 1, 20XX, to June 30, 20XX. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the controls in existence. The potential effectiveness of specific controls at the Service Organization ***and Computer Processing Service Organization*** is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.[1]

This report is intended solely for use by the management of Example Trust Company, its users, and the independent auditors of its users.

July 10, 20XX

[Issue Date: April, 1995; Revised: February, 1997; Revised: April, 2002.]

[3.] Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls

[.19–.34] [Withdrawn July, 2000 by the Audit Issues Task Force.]

4. Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls

.35 *Question—Section 324.32 requires a service auditor to consider "whether any other information, irrespective of specified control objectives, has come to his or her attention that causes him or her to conclude (a)* that design deficiencies exist that could adversely affect the ability to initiate, record, process, or report financial data to user organizations without error, and (*b*) that user organizations would not generally be expected to have controls in place to mitigate such design deficiencies." A service auditor performing a service auditor's engagement may become aware that a service organization, whose system is correctly processing data during the period covered by the service auditor's examination, has not performed contingency planning or made adequate provision for disaster recovery, and may not be able to retrieve or process data in future periods. Does section 324.32 require a service auditor to identify, in his or her report, design deficiencies that do not affect processing during the period covered by the service auditor's examination but may represent potential problems in future periods?

.36 *Interpretation*—No. Section 324.32 addresses design deficiencies that could adversely affect processing *during the period covered by the service auditor's examination*. Section 324.32 does not apply to design deficiencies that potentially could affect processing *in future periods*. If the computer programs are correctly processing data during the period covered by the service auditor's examination, and such design deficiencies currently do not affect user

[1] This sentence has been expanded to describe the risks of projecting any evaluation of the controls to future periods because of the failure to make needed changes to a system or controls, as provided for in Interpretation No. 5, "Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods" (paragraphs .38–.40).

organizations' abilities to initiate, record, process, or report financial data, the service auditor would not be required to report such design deficiencies in his or her report, based on the requirements in section 324.32. However, if a service auditor becomes aware of design deficiencies at the service organization that could potentially affect the processing of user organizations' transactions in future periods, the service auditor, in his or her judgment, may choose to communicate this information to the service organization's management and advise management to disclose this information and its plans for correcting the design deficiencies in a section of the service auditor's document titled "Other Information Provided by the Service Organization."[2]

.37 If the service organization includes information about the design deficiencies in the section of the document titled "Other Information Provided by the Service Organization," the service auditor should read the information and consider applying by analogy the guidance in section 550, *Other Information in Documents Containing Audited Financial Statements*. In addition, the service auditor should include a paragraph in his or her report disclaiming an opinion on the information provided by the service organization. The following is an example of such a paragraph.

> The information in section 4 describing XYZ Service Organization's plans to modify its disaster recovery plan is presented by the Service Organization to provide additional information and is not a part of the Service Organization's description of controls that may be relevant to a user organization's internal control. Such information has not been subjected to the procedures applied in the examination of the description of the controls applicable to the processing of transactions for user organizations and, accordingly, we express no opinion on it.

A service auditor also may consider communicating information about the design deficiencies in the section of the service auditor's document titled "Other Information Provided by the Service Auditor."

[Issue Date: February, 2002.]

5. Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods

.38 *Question*—Section 324.29*g* and .44*l* state that a service auditor's report should contain a statement of the inherent limitations of the potential effectiveness of controls at the service organization and of the risk of projecting to future periods any evaluation of the description. Section 324.44*l* goes on to state that the report also should refer to the risk of projecting to the future "any conclusions about the effectiveness of controls in achieving control objectives." The sample service auditor's reports in section 324.38 and .54 include

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[2] Chapter 2 of the AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*, proposes four sections of a service auditor's document.

1. Independent service auditor's report (the letter from the service auditor expressing his or her opinion)
2. Service organization's description of controls
3. Information provided by the independent service auditor (This section generally contains a description of the service auditor's tests of operating effectiveness and the results of those tests.)
4. Other information provided by the service organization

illustrative paragraphs that illustrate this caveat. The following excerpt is from section 324.54:

> The description of controls at XYZ Service Organization is as of_____, and information about tests of the operating effectiveness of specific controls covers the period from _____to _____. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the controls in existence. The potential effectiveness of specific controls at the Service Organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

The validity of projections to the future about the effectiveness of controls may be affected by changes made to the system and the controls, and also by the failure to make needed changes, for example, changes to accommodate new processing requirements. May a service auditor's report be expanded to describe the risk of projecting to the future conclusions about the effectiveness of controls?

.39 *Interpretation*—The sample reports in section 324.38 and .54 may be expanded to describe this risk. The first and second sentences of the illustrative paragraph above address the potential effect of change on the description of controls as of a specified date; accordingly, they do not require modification because new processing requirements would not affect the description as of the specified date. However, the last sentence in the sample report paragraph above could be expanded to describe the risk of projecting an evaluation of the controls to future periods because of changes to the system or controls, or the failure to make needed changes to the system or controls.

.40 Suggested additions to the paragraph in the illustrative service auditor's reports in section 324.38 and .54 are the following (new language is shown in italics.):

> The description of controls at XYZ Service Organization is as of _____, and information about tests of the operating effectiveness of specific controls covers the period from _____ to _____. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the controls in existence. The potential effectiveness of specific controls at the Service Organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes *made to the system or controls, or the failure to make needed changes to the system or controls,* may alter the validity of such conclusions.

[Issue Date: February, 2002.]

[6.] Responsibilities of Service Organizations and Service Auditors With Respect to Subsequent Events in a Service Auditor's Engagement

.41 [Rescinded September, 2002, by Statement on Auditing Standards No. 98.]

AU Section 325

Communications About Control Deficiencies in an Audit of Financial Statements

Source: Auditing Standard No. 5.

[The following is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]

AU section 325 is superseded as follows:

- *In an integrated audit of financial statements and internal control over financial reporting, by paragraphs 78–84 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*
- *In an audit of financial statements only, by the following paragraphs.*

1. In an audit of financial statements, the auditor may identify deficiencies in the company's internal control over financial reporting. A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective is not always met.
- A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

2. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control over financial reporting, that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

3. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Note: There is a reasonable possibility of an event when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in paragraph 3 of Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*.

Note: In evaluating whether a deficiency exists and whether deficiencies, either individually or in combination with other deficiencies, are material weaknesses, the auditor should follow the direction in paragraphs 62–70 of PCAOB Auditing

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

4. The auditor must communicate in writing to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on the financial statements. The auditor's communication should distinguish clearly between those matters considered significant deficiencies and those considered material weaknesses, as defined in paragraphs 2 and 3.

Note: If no such committee exists with respect to the company, all references to the audit committee in this standard apply to the entire board of directors of the company.[1] The auditor should be aware that companies whose securities are not listed on a national securities exchange or an automated inter-dealer quotation system of a national securities association (such as the New York Stock Exchange, American Stock Exchange, or NASDAQ) may not be required to have independent directors for their audit committees. In this case, the auditor should not consider the lack of independent directors or an audit committee at these companies indicative, by themselves, of a control deficiency. Likewise, the independence requirements of Securities Exchange Act Rule 10A-3[2] are not applicable to the listing of non-equity securities of a consolidated or at least 50 percent beneficially owned subsidiary of a listed issuer that is subject to the requirements of Securities Exchange Act Rule 10A-3(c)(2).[3] Therefore, the auditor should interpret references to the audit committee in this standard, as applied to a subsidiary registrant, as being consistent with the provisions of Securities Exchange Act Rule 10A-3(c)(2).[4] Furthermore, for subsidiary registrants, communications required by this standard to be directed to the audit committee should be made to the same committee or equivalent body that pre-approves the retention of the auditor by or on behalf of the subsidiary registrant pursuant to Rule 2-01(c)(7) of Regulation S-X[5] (which might be, for example, the audit committee of the subsidiary registrant, the full board of the subsidiary registrant, or the audit committee of the subsidiary registrant's parent). In all cases, the auditor should interpret the terms "board of directors" and "audit committee" in this standard as being consistent with provisions for the use of those terms as defined in relevant SEC rules.

5. If oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, that circumstance should be regarded as an indicator that a material weakness in internal control over financial reporting exists. Although there is not an explicit requirement to evaluate the effectiveness of the audit committee's oversight in an audit of only the financial statements, if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that information in writing to the board of directors.

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[1] See 15 U.S.C. 78c(a)58 and 15 U.S.C. 7201(a)(3).

[2] See 17 C.F.R. 240.10A-3.

[3] See 17 C.F.R. 240.10A-3(c)(2).

[4] See 17 C.F.R. 240.10A-3(c)(2).

[5] See 17 C.F.R. 210-2-01(c)(7).

6. These written communications should include:

a. The definitions of significant deficiencies and material weaknesses and should clearly distinguish to which category the deficiencies being communicated relate.

b. A statement that the objective of the audit was to report on the financial statements and not to provide assurance on internal control.

c. A statement that the communication is intended solely for the information and use of the board of directors, audit committee, management, and others within the organization. When there are requirements established by governmental authorities to furnish such written communications, specific reference to such regulatory authorities may be made.

7. The auditor might identify matters in addition to those required to be communicated by this standard. Such matters include control deficiencies identified by the auditor that are neither significant deficiencies nor material weaknesses and matters the company may request the auditor to be alert to that go beyond those contemplated by this standard. The auditor may report such matters to management, the audit committee, or others, as appropriate.

8. The auditor should not report in writing that no significant deficiencies were discovered during an audit of financial statements because of the potential that the limited degree of assurance associated with such a report will be misunderstood.

9. When timely communication is important, the auditor should communicate the preceding matters during the course of the audit rather than at the end of the engagement. The decision about whether to issue an interim communication should be determined based on the relative significance of the matters noted and the urgency of corrective follow-up action required. In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency," as defined in paragraph 2 of this standard.

AU Section 9325

Communication of Internal Control Related Matters Noted in an Audit: Auditing Interpretations of Section 325

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]

Note: In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph 2 of this standard. Within the example report within paragraph 4 of the interpretation, the third sentence is replaced with the definition of a material weakness in paragraph A7 of Appendix A, *Definitions*, of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

1. Reporting on the Existence of Material Weaknesses

.01 *Question*—Section 325 requires the auditor to report to the audit committee or to individuals with equivalent authority and responsibility significant deficiencies noted during an audit of financial statements. It permits the issuance of reports that include a statement about whether any of the significant deficiencies identified are material weaknesses. In connection with an audit, may the auditor issue a written report on material weaknesses separate from the report on significant deficiencies?

.02 *Interpretation*—Yes. Section 325 does not preclude the auditor from issuing a separate report stating whether he or she noted any material weaknesses during the audit. Reports on material weaknesses should—

- Indicate that the purpose of the audit was to report on the financial statements and not to provide assurance on internal control.
- Include the definition of a material weakness.
- State that the communication is intended solely for the information and the use of the audit committee, management, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. When there are requirements established by governmental agencies to furnish such reports, specific reference to such regulatory authorities may be made.

.03 Section 325 prohibits the auditor from issuing a written report representing that no significant deficiencies were noted during the audit. Therefore, in issuing a report stating that no material weaknesses were noted, the auditor should not imply that no significant deficiencies were noted.

.04 The following is an illustration of a report encompassing the above requirements:

> In planning and performing our audit of the financial statements of ABC Corporation for the year ended December 31, 19XX, we considered its internal control in order to determine our auditing procedures for the purpose of expressing our

opinion on the financial statements and not to provide assurance on the internal control. Our consideration of the internal control would not necessarily disclose all matters in the internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control and its operation that we consider to be material weaknesses as defined above.

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others within the organization (or specified regulatory agency) and is not intended to be and should not be used by anyone other than these specified parties.

.05 If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention. The last sentence of the first paragraph of the report illustrated in paragraph .04 should be modified as follows and paragraphs describing the material weaknesses should follow the first paragraph:

However, we noted the following matters involving internal control and its operation that we consider to be material weaknesses as defined above.

.06 In some cases reports on material weaknesses may include comments on specific aspects of internal control or on additional matters. For example, a regulatory agency may require comments on the accounting system and controls (but not on the control environment) or on compliance with certain provisions in contracts or regulations. In such cases the language in paragraph .04 should be modified to:

a. identify clearly the specific aspects of internal controls or the additional matters covered by the report

b. distinguish any additional matters from internal control

c. describe in reasonable detail the scope of the review and tests concerning the additional matters

d. express conclusions in language comparable to that in paragraph .04 or .05, as appropriate

.07 The identification of the specific aspects of internal control or additional matters covered in the report should be as specific as the auditor considers necessary to prevent misunderstanding in this respect. Such identification can be made in some cases by reference to specific portions of other documents such as contracts or regulations.

[Issue Date: February, 1989; Revised: February, 1999; Revised October, 2007.]

[2.] Audit Considerations for the Year 2000 Issue

[.08–.17] [Withdrawn July, 2000 by the Audit Issues Task Force.]

AU Section 326

Evidential Matter

[This section was superseded, effective December 15, 2010, by PCAOB Auditing Standard Nos. 8–15. See PCAOB Release No. 2010-004.]

[See Auditing Standard No. 15, Audit Evidence*, in the "Auditing Standards" section.]*

AU Section 9326

Evidential Matter: Auditing Interpretations of Section 326

Source: Auditing Standard Nos. 8–15.

[1.] Evidential Matter for an Audit of Interim Financial Statements

[.01–.05]

[Paragraphs .01–.05 deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]

2. The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals

.06 *Question*—The Internal Revenue Service's audit manual instructs its examiners on how to secure from corporate officials "tax accrual workpapers" or the "tax liability contingency analysis," including, "a memorandum discussing items reflected in the financial statements as income or expense where the ultimate tax treatment is unclear." The audit manual states that the examiner may question or summons a corporate officer or manager concerning the "knowledge of the items that make up the corporation's contingent reserve accounts." It also states that "in unusual circumstances, access may be had to the audit or tax workpapers" of an independent accountant or an accounting firm after attempting to obtain the information from the taxpayer. IRS policy also includes specific procedures to be followed in circumstances involving "Listed Transactions," to help address what the IRS considers to be abusive tax avoidance transactions (Internal Revenue Manual, section 4024.2-.5, 5/14/81, and Internal Revenue Service Announcement 2002-63, 6/17/02).

.07 Concern over IRS access to tax accrual working papers might cause some clients to not prepare or maintain appropriate documentation of the calculation or contents of the accrual for income taxes included in the financial statements, or to deny the independent auditor access to such information.

.08 What effect does this situation have on the auditor's opinion on the financial statements?

.09 *Interpretation*—The client is responsible for its tax accrual, the underlying support for the accrual, and the related disclosures. Limitations on the auditor's access to information considered necessary to audit the tax accrual will affect the auditor's ability to issue an unqualified opinion on the financial statements. Thus, if the client does not have appropriate documentation of the calculation or contents of the accrual for income taxes and denies the auditor access to client personnel responsible for making the judgments and estimates relating to the accrual, the auditor should assess the importance of that inadequacy in the accounting records and the client imposed limitation on his or her ability to form an opinion on the financial statements. Also, if the client has appropriate documentation but denies the auditor access to it and to client personnel who possess the information, the auditor should assess the importance of the client-imposed scope limitation on his or her ability to form an opinion.

.10 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The third standard of field work requires the auditor to obtain sufficient appropriate evidential matter through, among other things, inspection and inquiries to afford a reasonable basis for an opinion on the financial statements. Paragraph 35 of Auditing Standard No. 14, *Evaluating Audit Results*, requires the auditor to obtain sufficient appropriate evidential matter about assertions in the financial statements of material significance or else to qualify or disclaim his or her opinion on the statements. Section 508, *Reports on Audited Financial Statements*, paragraph .24, states that, "When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements." Also, section 333 on *Management Representations* requires the auditor to obtain written representations from management. Section 333.06 states that specific representations should relate to the following matters, "availability of all financial records and related data," and section 333.08 states that a materiality limit does not apply to that representation. Section 333.13 states that "management's refusal to furnish a written representation" constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.11 *Question*—A client may allow the auditor to inspect its tax accrual workpapers, but request that copies not be retained for audit documentation, particularly copies of the tax liability contingency analysis. The client also may suggest that the auditor not prepare and maintain similar documentation of his or her own. What should the auditor consider in deciding a response to such a request?

.12 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Interpretation—Section 339, *Audit Documentation*, states that audit documentation is the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement. Audit documentation should include sufficient appropriate evidential matter to afford a reasonable basis for an opinion. In addition, audit documentation should be sufficient to enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of auditing procedures performed, and the evidence obtained.

.13 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor's documentation of the results of auditing procedures directed at the tax accounts and related disclosures also should include sufficient appropriate evidential matter about the significant elements of the client's tax liability contingency analysis. This documentation should include copies of the client's documents, schedules, or analyses (or auditor-prepared summaries thereof) to enable the auditor to support his or her conclusions regarding the appropriateness of the client's accounting and disclosure of significant tax-related contingency matters. The audit documentation should reflect the procedures performed and conclusions reached by the auditor and, for significant matters, include the client's documentary support for its financial statement amounts and disclosures.

.14 The audit documentation should include the significant elements of the client's analysis of tax contingencies or reserves, including roll-forward of material changes to such reserves. In addition, the documentation should provide the client's position and support for income tax related disclosures, such as its effective tax rate reconciliation, and support for its intra-period allocation

of income tax expense or benefit to continuing operations and to items other than continuing operations. Where applicable, the documentation also should include the client's basis for assessing deferred tax assets and related valuation allowances and its support for applying the "indefinite reversal criteria" in APB Opinion No. 23, *Accounting for Income Taxes—Special Areas*, including its specific plans for reinvestment of undistributed foreign earnings.

.15 *Question*—In some situations, a client may furnish its outside legal counsel or in-house legal or tax counsel with information concerning the tax contingencies covered by the accrual for income taxes included in the financial statements and ask counsel to provide the auditor an opinion on the adequacy of the accrual for those contingencies.

.16 In such circumstances, rather than inspecting and obtaining documentary evidence of the client's tax liability contingency analysis and making inquiries of the client, may the auditor consider the counsel as a specialist within the meaning of section 336, *Using the Work of a Specialist*, and rely solely on counsel's opinion as an appropriate procedure for obtaining evidential matter to support his or her opinion on the financial statements?

.17 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Interpretation—No. The opinion of legal counsel in this situation would not provide sufficient appropriate evidential matter to afford a reasonable basis for an opinion on the financial statements.

.18 Section 336.01 defines a specialist as "a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing." It is intended to apply to situations requiring special knowledge of matters about which the auditor does not have adequate technical training and proficiency. The auditor's education, training, and experience, on the other hand, do enable him or her to be knowledgeable concerning income tax matters and competent to assess their presentation in the financial statements.

.19 The opinion of legal counsel on specific tax issues that he or she is asked to address and to which he or she has devoted substantive attention, as contemplated by section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, can be useful to the auditor in forming his or her own opinion. However, the audit of income tax accounts requires a combination of tax expertise and knowledge about the client's business that is accumulated during all aspects of an audit. Therefore, as stated above, it is not appropriate for the auditor to rely solely on such legal opinion.

.20 *Question*—A client may have obtained the advice or opinion of an outside tax adviser related to the tax accrual or matters affecting it, including tax contingencies, and further may attempt to limit the auditor's access to such advice or opinion, or limit the auditor's documentation of such advice or opinion. This limitation on the auditor's access may be proposed on the basis that such information is privileged. Can the auditor rely solely on the conclusions of third party tax advisers? What evidential matter should the auditor obtain and include in the audit documentation?

.21 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Interpretation—As discussed in paragraphs .17 through .19 above, the auditor cannot accept a client's or a third party's analysis or opinion with respect to tax matters without careful consideration and application of the auditor's tax expertise and knowledge about the client's business. As a result of applying such knowledge to the facts, the auditor may encounter situations in which the

auditor either disagrees with the position taken by the client, or its advisers, or does not have sufficient appropriate evidential matter to support his or her opinion.

.22 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

If the client's support for the tax accrual or matters affecting it, including tax contingencies, is based upon an opinion issued by an outside adviser with respect to a potentially material matter, the auditor should obtain access to the opinion, notwithstanding potential concerns regarding attorney-client or other forms of privilege. The audit documentation should include either the actual advice or opinions rendered by an outside adviser, or other sufficient documentation or abstracts supporting both the transactions or facts addressed as well as the analysis and conclusions reached by the client and adviser. Alternatives such as redacted or modified opinions may be considered, but must nonetheless include sufficient content to articulate and document the client's position so that the auditor can formulate his or her conclusion. Similarly, it may be possible to accept a client's analysis summarizing an outside adviser's opinion, but the client's analysis must provide sufficient appropriate evidential matter for the auditor to formulate his or her conclusion. In addition, client representations may be obtained stating that the client has not received any advice or opinions that are contradictory to the client's support for the tax accrual.

.23 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

If the auditor is unable to accumulate sufficient appropriate evidence about whether there is a supported and reasonable basis for the client's position, the auditor should consider the effect of this scope limitation on his or her report.

[Issue Date: March, 1981; Amended: April 9, 2003.]

[3.] The Auditor's Consideration of the Completeness Assertion

[.24–.27] *[Paragraphs .24–.27 deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[4.] Applying Auditing Procedures to Segment Disclosures in Financial Statements

[.28–.41] *[Paragraphs .28–.41 deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

AU Section 328

Auditing Fair Value Measurements and Disclosures

Source: SAS No. 101; Auditing Standard No. 5; Auditing Standard No. 6; Auditing Standard Nos. 8–15; Auditing Standard No. 16.

Effective for audits of financial statements for periods beginning on or after June 15, 2003, unless otherwise indicated.

Introduction

.01 The purpose of this section is to establish standards and provide guidance on auditing fair value measurements and disclosures contained in financial statements. In particular, this section addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. Fair value measurements of assets, liabilities, and components of equity may arise from both the initial recording of transactions and later changes in value. Changes in fair value measurements that occur over time may be treated in different ways under generally accepted accounting principles (GAAP). For example, GAAP may require that some fair value changes be reflected in net income and that other fair value changes be reflected in other comprehensive income and equity.

.02 While this section provides guidance on auditing fair value measurements and disclosures, evidence obtained from other audit procedures also may provide evidence relevant to the measurement and disclosure of fair values. For example, inspection procedures to verify existence of an asset measured at fair value also may provide relevant evidence about its valuation, such as the physical condition of the asset.

.03 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor should obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP. GAAP requires that certain items be measured at fair value. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, defines the fair value of an asset (liability) as "the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale."[1] Although GAAP may not prescribe the

[1] Generally accepted accounting principles (GAAP) contain various definitions of fair value. However, all of the definitions reflect the concepts in the definition that appears in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. For example, Governmental Accounting Standards Board Statement of Governmental Accounting Standards No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, defines fair value as "the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale."

method for measuring the fair value of an item, it expresses a preference for the use of observable market prices to make that determination. In the absence of observable market prices, GAAP requires fair value to be based on the best information available in the circumstances.

.04 Management is responsible for making the fair value measurements and disclosures included in the financial statements. As part of fulfilling its responsibility, management needs to establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation, and ensure that the presentation and disclosure of the fair value measurements are in accordance with GAAP.

.05 Fair value measurements for which observable market prices are not available are inherently imprecise. That is because, among other things, those fair value measurements may be based on assumptions about future conditions, transactions, or events whose outcome is uncertain and will therefore be subject to change over time. The auditor's consideration of such assumptions is based on information available to the auditor at the time of the audit. The auditor is not responsible for predicting future conditions, transactions, or events that, had they been known at the time of the audit, may have had a significant effect on management's actions or management's assumptions underlying the fair value measurements and disclosures.[2]

.06 Assumptions used in fair value measurements are similar in nature to those required when developing other accounting estimates. However, if observable market prices are not available, GAAP requires that valuation methods incorporate assumptions that marketplace participants would use in their estimates of fair value whenever that information is available without undue cost and effort. If information about market assumptions is not available, an entity may use its own assumptions as long as there are no contrary data indicating that marketplace participants would use different assumptions. These concepts generally are not relevant for accounting estimates made under measurement bases other than fair value. Section 342, *Auditing Accounting Estimates*, provides guidance on auditing accounting estimates in general. This section addresses considerations similar to those in section 342 as well as others in the specific context of fair value measurements and disclosures in accordance with GAAP.

.07 GAAP requires or permits a variety of fair value measurements and disclosures in financial statements. GAAP also varies in the level of guidance that it provides on measuring fair values and disclosures. While this section provides guidance on auditing fair value measurements and disclosures, it does not address specific types of assets, liabilities, components of equity, transactions, or industry-specific practices.[3]

.08 The measurement of fair value may be relatively simple for certain assets or liabilities, for example, investments that are bought and sold in active markets that provide readily available and reliable information on the prices at which actual exchanges occur. For those items, the existence of published price quotations in an active market is the best evidence of fair value. The measurement of fair value for other assets or liabilities may be more complex.

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[2] For purposes of this section, management's assumptions include assumptions developed by management under the guidance of the board of directors and assumptions developed by a specialist engaged or employed by management.

[3] See, for example, section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

A specific asset may not have an observable market price or may possess such characteristics that it becomes necessary for management to estimate its fair value based on the best information available in the circumstances (for example, a complex derivative financial instrument). The estimation of fair value may be achieved through the use of a valuation method (for example, a model premised on discounting of estimated future cash flows).

Understanding the Entity's Process for Determining Fair Value Measurements and Disclosures and the Relevant Controls, and Assessing Risk

.09 The auditor should obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach.

.10 Management is responsible for establishing an accounting and financial reporting process for determining fair value measurements. In some cases, the measurement of fair value and therefore the process set up by management to determine fair value may be simple and reliable. For example, management may be able to refer to published price quotations in an active market to determine fair value for marketable securities held by the entity. Some fair value measurements, however, are inherently more complex than others and involve uncertainty about the occurrence of future events or their outcome, and therefore assumptions that may involve the use of judgment need to be made as part of the measurement process.

.11 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, requires the auditor to obtain an understanding of each of the five components of internal control sufficient to plan the audit. In the specific context of this section, the auditor obtains such an understanding related to the determination of the entity's fair value measurements and disclosures in order to plan the nature, timing, and extent of the audit procedures.

.12 When obtaining an understanding of the entity's process for determining fair value measurements and disclosures, the auditor considers, for example:

- Controls over the process used to determine fair value measurements, including, for example, controls over data and the segregation of duties between those committing the entity to the underlying transactions and those responsible for undertaking the valuations.
- The expertise and experience of those persons determining the fair value measurements.
- The role that information technology has in the process.
- The types of accounts or transactions requiring fair value measurements or disclosures (for example, whether the accounts arise from the recording of routine and recurring transactions or whether they arise from nonroutine or unusual transactions).
- The extent to which the entity's process relies on a service organization to provide fair value measurements or the data that supports the measurement. When an entity uses a service

organization, the auditor considers the requirements of section 324, *Service Organizations*, as amended.

- The extent to which the entity engages or employs specialists in determining fair value measurements and disclosures.
- The significant management assumptions used in determining fair value.
- The documentation supporting management's assumptions.
- The process used to develop and apply management assumptions, including whether management used available market information to develop the assumptions.
- The process used to monitor changes in management's assumptions.
- The integrity of change controls and security procedures for valuation models and relevant information systems, including approval processes.
- The controls over the consistency, timeliness, and reliability of the data used in valuation models.

.13 The auditor uses his or her understanding of the entity's process, including its complexity, and of the controls when assessing the risk of material misstatement. Based on that risk assessment, the auditor determines the nature, timing, and extent of the audit procedures. The risk of material misstatement may increase as the accounting and financial reporting requirements for fair value measurements become more complex.

.14 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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*, discusses the inherent limitations of internal control. As fair value determinations often involve subjective judgments by management, this may affect the nature of controls that are capable of being implemented, including the possibility of management override of controls. The auditor considers the inherent limitations of internal control in such circumstances in assessing control risk.

Evaluating Conformity of Fair Value Measurements and Disclosures With GAAP

.15 The auditor should evaluate whether the fair value measurements and disclosures in the financial statements are in conformity with GAAP. The auditor's understanding of the requirements of GAAP and knowledge of the business and industry, together with the results of other audit procedures, are used to evaluate the accounting for assets or liabilities requiring fair value measurements, and the disclosures about the basis for the fair value measurements and significant uncertainties related thereto.

.16 The evaluation of the entity's fair value measurements and of the audit evidence depends, in part, on the auditor's knowledge of the nature of the business. This is particularly true where the asset or liability or the valuation method is highly complex. For example, derivative financial instruments may be highly complex, with a risk that differing assumptions used in determining fair values will result in different conclusions. The measurement of the

fair value of some items, for example "in process research and development" or intangible assets acquired in a business combination, may involve special considerations that are affected by the nature of the entity and its operations. Also, the auditor's knowledge of the business, together with the results of other audit procedures, may help identify assets for which management should assess the need to recognize an impairment loss under applicable GAAP.

.17 The auditor should evaluate management's intent to carry out specific courses of action where intent is relevant to the use of fair value measurements, the related requirements involving presentation and disclosures, and how changes in fair values are reported in financial statements. The auditor also should evaluate management's ability to carry out those courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and GAAP may require it to do so. While the extent of evidence to be obtained about management's intent and ability is a matter of professional judgment, the auditor's procedures ordinarily include inquiries of management, with appropriate corroboration of responses, for example, by:

- Considering management's past history of carrying out its stated intentions with respect to assets or liabilities.
- Reviewing written plans and other documentation, including, where applicable, budgets, minutes, and other such items.
- Considering management's stated reasons for choosing a particular course of action.
- Considering management's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its contractual commitments.

.18 When there are no observable market prices and the entity estimates fair value using a valuation method, the auditor should evaluate whether the entity's method of measurement is appropriate in the circumstances. That evaluation requires the use of professional judgment. It also involves obtaining an understanding of management's rationale for selecting a particular method by discussing with management its reasons for selecting the valuation method. The auditor considers whether:

a. Management has sufficiently evaluated and appropriately applied the criteria, if any, provided by GAAP to support the selected method.

b. The valuation method is appropriate in the circumstances given the nature of the item being valued.

c. The valuation method is appropriate in relation to the business, industry, and environment in which the entity operates.

Management may have determined that different valuation methods result in a range of significantly different fair value measurements. In such cases, the auditor evaluates how the entity has investigated the reasons for these differences in establishing its fair value measurements.

.19 The auditor should evaluate whether the entity's method for determining fair value measurements is applied consistently and if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity, or changes in accounting principles. If management has changed the method for determining fair value, the auditor considers whether management can adequately demonstrate that the method to which it has changed provides a more appropriate basis of measurement or whether the change is supported by a change in the GAAP requirements or a

change in circumstances.[4] For example, the introduction of an active market for an equity security may indicate that the use of the discounted cash flows method to estimate the fair value of the security is no longer appropriate.

Engaging a Specialist

.20 The auditor should consider whether to engage a specialist and use the work of that specialist as evidential matter in performing substantive tests to evaluate material financial statement assertions. The auditor may have the necessary skill and knowledge to plan and perform audit procedures related to fair values or may decide to use the work of a specialist. If the use of such a specialist is planned, the auditor should consider the guidance in section 336, *Using the Work of a Specialist*.

.21 When planning to use the work of a specialist in auditing fair value measurements, the auditor considers whether the specialist's understanding of the definition of fair value and the method that the specialist will use to determine fair value are consistent with those of management and with GAAP. For example, the method used by a specialist for estimating the fair value of real estate or a complex derivative may not be consistent with the measurement principles specified in GAAP. Accordingly, the auditor considers such matters, often through discussions with the specialist or by reading the report of the specialist.

.22 Section 336 provides that, while the reasonableness of assumptions and the appropriateness of the methods used and their application are the responsibility of the specialist, the auditor obtains an understanding of the assumptions and methods used. However, if the auditor believes the findings are unreasonable, he or she applies additional procedures as required in section 336.

Testing the Entity's Fair Value Measurements and Disclosures

.23 Based on the auditor's assessment of the risk of material misstatement, the auditor should test the entity's fair value measurements and disclosures. Because of the wide range of possible fair value measurements, from relatively simple to complex, and the varying levels of risk of material misstatement associated with the process for determining fair values, the auditor's planned audit procedures can vary significantly in nature, timing, and extent. For example, substantive tests of the fair value measurements may involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data (see paragraphs .26 through .39), (*b*) developing independent fair value estimates for corroborative purposes (see paragraph .40), or (*c*) reviewing subsequent events and transactions (see paragraphs .41 and .42).

.24 Some fair value measurements are inherently more complex than others. This complexity arises either because of the nature of the item being measured at fair value or because of the valuation method used to determine fair value. For example, in the absence of quoted prices in an active market, an estimate of a security's fair value may be based on valuation methods such as the

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[4] *[The following footnote is effective November 15, 2008. See PCAOB Release 2008-001.]* Statement of Financial Accounting Standard No. 157, *Fair Value Measurements*, states that a change in valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances.

discounted cash flow method or the transactions method. Complex fair value measurements normally are characterized by greater uncertainty regarding the reliability of the measurement process. This greater uncertainty may be a result of:

- The length of the forecast period
- The number of significant and complex assumptions associated with the process
- A higher degree of subjectivity associated with the assumptions and factors used in the process
- A higher degree of uncertainty associated with the future occurrence or outcome of events underlying the assumptions used
- Lack of objective data when highly subjective factors are used

.25 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor uses both the understanding of management's process for determining fair value measurements and his or her assessment of the risk of material misstatement to determine the nature, timing, and extent of the audit procedures. The following are examples of considerations in the development of audit procedures:

- The fair value measurement (for example, a valuation by an independent appraiser) may be made at a date that does not coincide with the date at which the entity is required to measure and report that information in its financial statements. In such cases, the auditor obtains evidence that management has taken into account the effect of events, transactions, and changes in circumstances occurring between the date of the fair value measurement and the reporting date.
- Collateral often is assigned for certain types of investments in debt instruments that either are required to be measured at fair value or are evaluated for possible impairment. If the collateral is an important factor in measuring the fair value of the investment or evaluating its carrying amount, the auditor obtains sufficient appropriate audit evidence regarding the existence, value, rights, and access to or transferability of such collateral, including consideration of whether all appropriate liens have been filed, and considers whether appropriate disclosures about the collateral have been made.
- In some situations, additional procedures, such as the inspection of an asset by the auditor, may be necessary to obtain sufficient appropriate audit evidence about the appropriateness of a fair value measurement. For example, inspection of the asset may be necessary to obtain information about the current physical condition of the asset relevant to its fair value, or inspection of a security may reveal a restriction on its marketability that may affect its value.

Testing Management's Significant Assumptions, the Valuation Model, and the Underlying Data

.26 The auditor's understanding of the reliability of the process used by management to determine fair value is an important element in support of the resulting amounts and therefore affects the nature, timing, and extent of audit

procedures. When testing the entity's fair value measurements and disclosures, the auditor evaluates whether:

a. Management's assumptions are reasonable and reflect, or are not inconsistent with, market information (see paragraph .06).

b. The fair value measurement was determined using an appropriate model, if applicable.

c. Management used relevant information that was reasonably available at the time.

.27 Estimation methods and assumptions, and the auditor's consideration and comparison of fair value measurements determined in prior periods, if any, to results obtained in the current period, may provide evidence of the reliability of management's processes. However, the auditor also considers whether variances from the prior-period fair value measurements result from changes in market or economic circumstances.

.28 Where applicable, the auditor should evaluate whether the significant assumptions used by management in measuring fair value, taken individually and as a whole, provide a reasonable basis for the fair value measurements and disclosures in the entity's financial statements.

.29 Assumptions are integral components of more complex valuation methods, for example, valuation methods that employ a combination of estimates of expected future cash flows together with estimates of the values of assets or liabilities in the future, discounted to the present. Auditors pay particular attention to the significant assumptions underlying a valuation method and evaluate whether such assumptions are reasonable and reflect, or are not inconsistent with, market information (see paragraph .06).

.30 Specific assumptions will vary with the characteristics of the item being valued and the valuation approach used (for example, cost, market, or income). For example, where the discounted cash flows method (a method under the income approach) is used, there will be assumptions about the level of cash flows, the period of time used in the analysis, and the discount rate.

.31 Assumptions ordinarily are supported by differing types of evidence from internal and external sources that provide objective support for the assumptions used. The auditor evaluates the source and reliability of evidence supporting management's assumptions, including consideration of the assumptions in light of historical and market information.

.32 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Audit procedures dealing with management's assumptions are performed in the context of the audit of the entity's financial statements. The objective of the audit procedures is therefore not intended to obtain sufficient appropriate audit evidence to provide an opinion on the assumptions themselves. Rather, the auditor performs procedures to evaluate whether the assumptions provide a reasonable basis for measuring fair values in the context of an audit of the financial statements taken as a whole.

.33 Identifying those assumptions that appear to be significant to the fair value measurement requires the exercise of judgment by management. The auditor focuses attention on the significant assumptions that management has identified. Generally, significant assumptions cover matters that materially affect the fair value measurement and may include those that are:

a. Sensitive to variation or uncertainty in amount or nature. For example, assumptions about short-term interest rates may be

less susceptible to significant variation compared to assumptions about long-term interest rates.

b. Susceptible to misapplication or bias.

.34 The auditor considers the sensitivity of the valuation to changes in significant assumptions, including market conditions that may affect the value. Where applicable, the auditor encourages management to use techniques such as sensitivity analysis to help identify particularly sensitive assumptions. If management has not identified particularly sensitive assumptions, the auditor considers whether to employ techniques to identify those assumptions.

.35 The evaluation of whether the assumptions provide a reasonable basis for the fair value measurements relates to the whole set of assumptions as well as to each assumption individually. Assumptions are frequently interdependent and therefore need to be internally consistent. A particular assumption that may appear reasonable when taken in isolation may not be reasonable when used in conjunction with other assumptions. The auditor considers whether management has identified the significant assumptions and factors influencing the measurement of fair value.

.36 To be reasonable, the assumptions on which the fair value measurements are based (for example, the discount rate used in calculating the present value of future cash flows),[5] individually and taken as a whole, need to be realistic and consistent with:

a. The general economic environment, the economic environment of the specific industry, and the entity's economic circumstances;

b. Existing market information;

c. The plans of the entity, including what management expects will be the outcome of specific objectives and strategies;

d. Assumptions made in prior periods, if appropriate;

e. Past experience of, or previous conditions experienced by, the entity to the extent currently applicable;

f. Other matters relating to the financial statements, for example, assumptions used by management in accounting estimates for financial statement accounts other than those relating to fair value measurements and disclosures; and

g. The risk associated with cash flows, if applicable, including the potential variability in the amount and timing of the cash flows and the related effect on the discount rate.

Where assumptions are reflective of management's intent and ability to carry out specific courses of action, the auditor considers whether they are consistent with the entity's plans and past experience.

.37 If management relies on historical financial information in the development of assumptions, the auditor considers the extent to which such reliance is justified. However, historical information might not be representative of future conditions or events, for example, if management intends to engage in new activities or circumstances change.

.38 For items valued by the entity using a valuation model, the auditor does not function as an appraiser and is not expected to substitute his or her judgment for that of the entity's management. Rather, the auditor reviews the model and evaluates whether the assumptions used are reasonable and the

[5] The auditor also should consider requirements of GAAP that may influence the selection of assumptions (see FASB Concepts Statement No. 7).

model is appropriate considering the entity's circumstances. For example, it may be inappropriate to use discounted cash flows for valuing an equity investment in a start-up enterprise if there are no current revenues on which to base the forecast of future earnings or cash flows.

.39 The auditor should test the data used to develop the fair value measurements and disclosures and evaluate whether the fair value measurements have been properly determined from such data and management's assumptions. Specifically, the auditor evaluates whether the data on which the fair value measurements are based, including the data used in the work of a specialist, is accurate, complete, and relevant; and whether fair value measurements have been properly determined using such data and management's assumptions. The auditor's tests also may include, for example, procedures such as verifying the source of the data, mathematical recomputation of inputs, and reviewing of information for internal consistency, including whether such information is consistent with management's intent and ability to carry out specific courses of action discussed in paragraph .17.

Developing Independent Fair Value Estimates for Corroborative Purposes

.40 The auditor may make an independent estimate of fair value (for example, by using an auditor-developed model) to corroborate the entity's fair value measurement.[6] When developing an independent estimate using management's assumptions, the auditor evaluates those assumptions as discussed in paragraphs .28 to .37. Instead of using management's assumptions, the auditor may develop his or her own assumptions to make a comparison with management's fair value measurements. In that situation, the auditor nevertheless understands management's assumptions. The auditor uses that understanding to ensure that his or her independent estimate takes into consideration all significant variables and to evaluate any significant difference from management's estimate. The auditor also should test the data used to develop the fair value measurements and disclosures as discussed in paragraph .39.

Reviewing Subsequent Events and Transactions

.41 *[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]*

Events and transactions that occur after the balance-sheet date but before the date of the auditor's report (for example, a sale of an investment shortly after the balance-sheet date), may provide audit evidence regarding management's fair value measurements as of the balance-sheet date.[7] In such circumstances, the audit procedures described in paragraphs .26 through .40 may be minimized or unnecessary because the subsequent event or transaction can be used to substantiate the fair value measurement.

.42 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Some subsequent events or transactions may reflect changes in circumstances occurring after the balance-sheet date and thus do not constitute appropriate

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[6] See section 329, *Analytical Procedures*.

[7] The auditor's consideration of a subsequent event or transaction, as contemplated in this paragraph, is a substantive test and thus differs from the review of subsequent events performed pursuant to section 560, *Subsequent Events*.

evidence of the fair value measurement at the balance-sheet date (for example, the prices of actively traded marketable securities that change after the balance-sheet date). When using a subsequent event or transaction to substantiate a fair value measurement, the auditor considers only those events or transactions that reflect circumstances existing at the balance-sheet date.

Disclosures About Fair Values

.43 The auditor should evaluate whether the disclosures about fair values made by the entity are in conformity with GAAP.[8] Disclosure of fair value information is an important aspect of financial statements. Often, fair value disclosure is required because of the relevance to users in the evaluation of an entity's performance and financial position. In addition to the fair value information required under GAAP, some entities disclose voluntary additional fair value information in the notes to the financial statements.

.44 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

When auditing fair value measurements and related disclosures included in the notes to the financial statements, whether required by GAAP or disclosed voluntarily, the auditor ordinarily performs essentially the same types of audit procedures as those employed in auditing a fair value measurement recognized in the financial statements. The auditor obtains sufficient appropriate audit evidence that the valuation principles are appropriate under GAAP and are being consistently applied, and that the method of estimation and significant assumptions used are adequately disclosed in accordance with GAAP.

.45 The auditor evaluates whether the entity has made adequate disclosures about fair value information. If an item contains a high degree of measurement uncertainty, the auditor assesses whether the disclosures are sufficient to inform users of such uncertainty.[9]

.46 When disclosure of fair value information under GAAP is omitted because it is not practicable to determine fair value with sufficient reliability, the auditor evaluates the adequacy of disclosures required in these circumstances. If the entity has not appropriately disclosed fair value information required by GAAP, the auditor evaluates whether the financial statements are materially misstated.

Evaluating the Results of Audit Procedures

.47 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor should evaluate the sufficiency and competence of the audit evidence obtained from auditing fair value measurements and disclosures as well as the consistency of that evidence with other audit evidence obtained and evaluated during the audit. The auditor's evaluation of whether the fair value measurements and disclosures in the financial statements are in conformity with GAAP is performed in the context of the financial statements taken as a whole (see paragraphs 12 through 18 and 24 through 27 of Auditing Standard No. 14, *Evaluating Audit Results*).

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[8] See also paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[9] See Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

Management Representations

.48 Section 333, *Management Representations*, requires that the independent auditor obtain written representations from management as a part of an audit of financial statements performed in accordance with generally accepted auditing standards and provides guidance concerning the representations to be obtained. The auditor ordinarily should obtain written representations from management regarding the reasonableness of significant assumptions, including whether they appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity where relevant to the use of fair value measurements or disclosures.

.49 Depending on the nature, materiality, and complexity of fair values, management representations about fair value measurements and disclosures contained in the financial statements also may include representations about:

- The appropriateness of the measurement methods, including related assumptions, used by management in determining fair value and the consistency in application of the methods.
- The completeness and adequacy of disclosures related to fair values.
- Whether subsequent events require adjustment to the fair value measurements and disclosures included in the financial statements.

Communication With Audit Committees

.50 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

Paragraphs 12–13 of Auditing Standard No. 16, *Communications with Audit Committees*, require the auditor to communicate to the audit committee matters related to critical accounting estimates, which may include fair value measurements.

Effective Date

.51 This section is effective for audits of financial statements for periods beginning on or after June 15, 2003. Earlier application of the provisions of this section is permitted.

AU Section 329

Substantive Analytical Procedures

[Section title revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]

(Supersedes section 318)

Source: SAS No. 56; SAS No. 96; Auditing Standard No. 2; Auditing Standard Nos. 8–15.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

.01 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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.

.02 Analytical procedures are an important part of the audit process and consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures range from simple comparisons to the use of complex models involving many relationships and elements of data. A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary. Particular conditions that can cause variations in these relationships include, for example, specific unusual transactions or events, accounting changes, business changes, random fluctuations, or misstatements.

.03 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Understanding financial relationships is essential in planning and evaluating the results of analytical procedures, and generally requires knowledge of the client and the industry or industries in which the client operates. An understanding of the purposes of analytical procedures and the limitations of those procedures is also important.

.04 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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.

.05 Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:

a. Financial information for comparable prior period(s) giving consideration to known changes

b. Anticipated results—for example, budgets, or forecasts including extrapolations from interim or annual data

c. Relationships among elements of financial information within the period

d. Information regarding the industry in which the client operates—for example, gross margin information

e. Relationships of financial information with relevant nonfinancial information

[.06–.08] *[Paragraphs .06–.08 and preceding heading, "Analytical Procedures in Planning the Audit," deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Analytical Procedures Used as Substantive Tests

.09 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor's reliance on substantive tests to achieve an audit objective related to a particular assertion[1] may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedure or procedures to use to achieve a particular audit objective is based on the auditor's judgment on the expected effectiveness and efficiency of the available procedures. For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient. (See paragraph 11 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.)

.10 *[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2004, for accelerated filers, and on or after July 15, 2005, for all other issuers. PCAOB Release No. 2004-008.]*

The auditor considers the level of assurance, if any, he wants from substantive testing for a particular audit objective and decides, among other things, which procedure, or combination of procedures, can provide that level of assurance. For some assertions, analytical procedures are effective in providing the appropriate level of assurance. For other assertions, however, analytical procedures may not be as effective or efficient as tests of details in providing the desired level of assurance. When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being

[1] Assertions are representations by management that are embodied in financial statement components. See Auditing Standard No. 15, *Audit Evidence*. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud.

.11 The expected effectiveness and efficiency of an analytical procedure in identifying potential misstatements depends on, among other things, (*a*) the nature of the assertion, (*b*) the plausibility and predictability of the relationship, (*c*) the availability and reliability of the data used to develop the expectation, and (*d*) the precision of the expectation.

Nature of Assertion

.12 Analytical procedures may be effective and efficient tests for assertions in which potential misstatements would not be apparent from an examination of the detailed evidence or in which detailed evidence is not readily available. For example, comparisons of aggregate salaries paid with the number of personnel may indicate unauthorized payments that may not be apparent from testing individual transactions. Differences from expected relationships may also indicate potential omissions when independent evidence that an individual transaction should have been recorded may not be readily available.

Plausibility and Predictability of the Relationship

.13 It is important for the auditor to understand the reasons that make relationships plausible because data sometimes appear to be related when they are not, which could lead the auditor to erroneous conclusions. In addition, the presence of an unexpected relationship can provide important evidence when appropriately scrutinized.

.14 As higher levels of assurance are desired from analytical procedures, more predictable relationships are required to develop the expectation. Relationships in a stable environment are usually more predictable than relationships in a dynamic or unstable environment. Relationships involving income statement accounts tend to be more predictable than relationships involving only balance sheet accounts since income statement accounts represent transactions over a period of time, whereas balance sheet accounts represent amounts as of a point in time. Relationships involving transactions subject to management discretion are sometimes less predictable. For example, management may elect to incur maintenance expense rather than replace plant and equipment, or they may delay advertising expenditures.

Availability and Reliability of Data

.15 Data may or may not be readily available to develop expectations for some assertions. For example, to test the completeness assertion, expected sales for some entities might be developed from production statistics or square feet of selling space. For other entities, data relevant to the assertion of completeness of sales may not be readily available, and it may be more effective or efficient to use the details of shipping records to test that assertion.

.16 *[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2004, for accelerated filers, and on or after July 15, 2005, for all other issuers. See PCAOB Release No. 2004-008.]*

Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying

information. The auditor obtains assurance from analytical procedures based upon the consistency of the recorded amounts with expectations developed from data derived from other sources. The reliability of the data used to develop the expectations should be appropriate for the desired level of assurance from the analytical procedure. The auditor should assess the reliability of the data by considering the source of the data and the conditions under which it was gathered, as well as other knowledge the auditor may have about the data. The following factors influence the auditor's consideration of the reliability of data for purposes of achieving audit objectives:

- Whether the data was obtained from independent sources outside the entity or from sources within the entity
- Whether sources within the entity were independent of those who are responsible for the amount being audited
- Whether the data was developed under a reliable system with adequate controls
- Whether the data was subjected to audit testing in the current or prior year
- Whether the expectations were developed using data from a variety of sources

Precision of the Expectation

.17 The expectation should be precise enough to provide the desired level of assurance that differences that may be potential material misstatements, individually or when aggregated with other misstatements, would be identified for the auditor to investigate (see paragraph .20). As expectations become more precise, the range of expected differences becomes narrower and, accordingly, the likelihood increases that significant differences from the expectations are due to misstatements. The precision of the expectation depends on, among other things, the auditor's identification and consideration of factors that significantly affect the amount being audited and the level of detail of data used to develop the expectation.

.18 Many factors can influence financial relationships. For example, sales are affected by prices, volume and product mix. Each of these, in turn, may be affected by a number of factors, and offsetting factors can obscure misstatements. More effective identification of factors that significantly affect the relationship is generally needed as the desired level of assurance from analytical procedures increases.

.19 Expectations developed at a detailed level generally have a greater chance of detecting misstatement of a given amount than do broad comparisons. Monthly amounts will generally be more effective than annual amounts and comparisons by location or line of business usually will be more effective than company-wide comparisons. The level of detail that is appropriate will be influenced by the nature of the client, its size and its complexity. Generally, the risk that material misstatement could be obscured by offsetting factors increases as a client's operations become more complex and more diversified. Disaggregation helps reduce this risk.

Investigation and Evaluation of Significant Differences

.20 In planning the analytical procedures as a substantive test, the auditor should consider the amount of difference from the expectation that can

be accepted without further investigation. This consideration is influenced primarily by materiality and should be consistent with the level of assurance desired from the procedures. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balances, or class of transactions, or other balances or classes could aggregate to an unacceptable amount.[2]

.21 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor should evaluate significant unexpected differences. Reconsidering the methods and factors used in developing the expectation and inquiry of management may assist the auditor in this regard. Management responses, however, should ordinarily be corroborated with other evidential matter. In those cases when an explanation for the difference cannot be obtained, the auditor should obtain sufficient evidence about the assertion by performing other audit procedures to satisfy himself as to whether the difference is a misstatement.[3] In designing such other procedures, the auditor should consider that unexplained differences may indicate an increased risk of material misstatement. (See Auditing Standard No. 14, *Evaluating Audit Results*.)

Documentation of Substantive Analytical Procedures

.22 When an analytical procedure is used as the principal substantive test of a significant financial statement assertion, the auditor should document all of the following:

a. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development

b. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts

c. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures

[Paragraph added, effective for audits of financial statements for periods beginning on or after May 15, 2002, by Statement on Auditing Standards No. 96.]

[.23] *[Paragraph .23 and preceding heading, "Analytical Procedures Used in the Overall Review," deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[.24] *[Paragraph .24 and preceding heading, "Effective Date," deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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[2] *[Footnote deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[3] *[Footnote deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

AU Section 330

The Confirmation Process

(Supersedes section 331.03–.08)

Source: SAS No. 67; Auditing Standard Nos. 8–15.

Effective for audits of fiscal periods ending after June 15, 1992, unless otherwise indicated.

Introduction and Applicability

.01 This section provides guidance about the confirmation process in audits performed in accordance with generally accepted auditing standards. This section—

- Defines the confirmation process (see paragraph .04).
- Discusses the relationship of confirmation procedures to the auditor's assessment of audit risk (see paragraphs .05 through .10).
- Describes certain factors that affect the reliability of confirmations (see paragraphs .16 through .27).
- Provides guidance on performing alternative procedures when responses to confirmation requests are not received (see paragraphs .31 and .32).
- Provides guidance on evaluating the results of confirmation procedures (see paragraph .33).
- Specifically addresses the confirmation of accounts receivable and supersedes section 331, *Inventories*, paragraphs .03-.08 and the portion of section 331.01 that addresses the confirmation of receivables (see paragraphs .34 and .35). This section does not supersede the portion of section 331.01 that addresses the observation of inventories.

.02 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

This section does not address the extent or timing of confirmation procedures. Guidance on the extent of audit procedures (that is, considerations involved in determining the number of items to confirm) is found in section 350, *Audit Sampling*, and Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*. Guidance on the timing of audit procedures is included in Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

.03 In addition, this section does not address matters described in section 336, *Using the Work of a Specialist*, or in section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

Definition of the Confirmation Process

.04 Confirmation is the process of obtaining and evaluating a direct communication from a third party in response to a request for information about a particular item affecting financial statement assertions. The process includes—

- Selecting items for which confirmations are to be requested.
- Designing the confirmation request.
- Communicating the confirmation request to the appropriate third party.
- Obtaining the response from the third party.
- Evaluating the information, or lack thereof, provided by the third party about the audit objectives, including the reliability of that information.

Relationship of Confirmation Procedures to the Auditor's Assessment of Audit Risk

.05 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Auditing Standard No. 8, *Audit Risk*, discusses the audit risk model. It describes the concept of assessing inherent and control risks, determining the acceptable level of detection risk, and designing an audit program to achieve an appropriately low level of audit risk. The auditor uses the audit risk assessment in determining the audit procedures to be applied, including whether they should include confirmation.

.06 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Confirmation is undertaken to obtain evidence from third parties about financial statement assertions made by management. See paragraph 8 of Auditing Standard No. 15, *Audit Evidence*, which discusses the reliability of audit evidence.

.07 The greater the combined assessed level of inherent and control risk, the greater the assurance that the auditor needs from substantive tests related to a financial statement assertion. Consequently, as the combined assessed level of inherent and control risk increases, the auditor designs substantive tests to obtain more or different evidence about a financial statement assertion. In these situations, the auditor might use confirmation procedures rather than or in conjunction with tests directed toward documents or parties within the entity.

.08 Unusual or complex transactions may be associated with high levels of inherent risk and control risk. If the entity has entered into an unusual or complex transaction and the combined assessed level of inherent and control risk is high, the auditor should consider confirming the terms of the transaction with the other parties in addition to examining documentation held by the entity. For example, if the combined assessed level of inherent and control risk over the occurrence of revenue related to an unusual, year-end sale is high, the auditor should consider confirming the terms of that sale.

.09 The auditor should assess whether the evidence provided by confirmations reduces audit risk for the related assertions to an acceptably low level. In making that assessment, the auditor should consider the materiality of the account balance and his or her inherent and control risk assessments. When the auditor concludes that evidence provided by confirmations alone is not sufficient, additional procedures should be performed. For example, to achieve an appropriately low level of audit risk related to the completeness and existence assertions for accounts receivable, an auditor may perform sales cutoff tests in addition to confirming accounts receivable.

.10 The lower the combined assessed level of inherent and control risk, the less assurance the auditor needs from substantive tests to form a conclusion about a financial statement assertion. Consequently, as the combined assessed level of inherent and control risk decreases for a particular assertion, the auditor may modify substantive tests by changing their nature from more effective (but costly) tests to less effective (and less costly) tests. For example, if the combined assessed level of inherent and control risk over the existence of cash is low, the auditor might limit substantive procedures to inspecting client-provided bank statements rather than confirming cash balances.

Assertions Addressed by Confirmations

.11 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

For the evidence obtained to be appropriate, it must be reliable and relevant. Factors affecting the reliability of confirmations are discussed in paragraphs .16 through .27. The relevance of evidence depends on its relationship to the financial statement assertion being addressed. Auditing Standard No. 15, *Audit Evidence*, classifies financial statement assertions into five categories:

a. Existence or occurrence

b. Completeness

c. Rights and obligations

d. Valuation or allocation

e. Presentation and disclosure

.12 Confirmation requests, if properly designed by the auditor, may address any one or more of those assertions. However, confirmations do not address all assertions equally well. Confirmation of goods held on consignment with the consignee would likely be more effective for the existence and the rights-and-obligations assertions than for the valuation assertion. Accounts receivable confirmations are likely to be more effective for the existence assertion than for the completeness and valuation assertions. Thus, when obtaining evidence for assertions not adequately addressed by confirmations, auditors should consider other audit procedures to complement confirmation procedures or to be used instead of confirmation procedures.

.13 Confirmation requests can be designed to elicit evidence that addresses the completeness assertion: that is, if properly designed, confirmations may provide evidence to aid in assessing whether all transactions and accounts that should be included in the financial statements are included. Their effectiveness in addressing the completeness assertion depends, in part, on whether the auditor selects from an appropriate population for testing. For example, when using confirmations to provide evidence about the completeness assertion for accounts payable, the appropriate population might be a list of vendors rather than the amounts recorded in the accounts payable subsidiary ledger.

.14 Some confirmation requests are not designed to elicit evidence regarding the completeness assertion. For example, the AICPA Standard Form to Confirm Account Balance Information With Financial Institutions is designed to substantiate information that is stated on the confirmation request; the form is not designed to provide assurance that information about accounts not listed on the form will be reported.

The Confirmation Process

.15 The auditor should exercise an appropriate level of professional skepticism throughout the confirmation process (see section 230, *Due Professional Care in the Performance of Work*). Professional skepticism is important in designing the confirmation request, performing the confirmation procedures, and evaluating the results of the confirmation procedures.

Designing the Confirmation Request

.16 Confirmation requests should be tailored to the specific audit objectives. Thus, when designing the confirmation requests, the auditor should consider the assertion(s) being addressed and the factors that are likely to affect the reliability of the confirmations. Factors such as the form of the confirmation request, prior experience on the audit or similar engagements, the nature of the information being confirmed, and the intended respondent should affect the design of the requests because these factors have a direct effect on the reliability of the evidence obtained through confirmation procedures.

Form of Confirmation Request

.17 There are two types of confirmation requests: the positive form and the negative form. Some positive forms request the respondent to indicate whether he or she agrees with the information stated on the request. Other positive forms, referred to as blank forms, do not state the amount (or other information) on the confirmation request, but request the recipient to fill in the balance or furnish other information.

.18 Positive forms provide audit evidence only when responses are received from the recipients; nonresponses do not provide audit evidence about the financial statement assertions being addressed.

.19 Since there is a risk that recipients of a positive form of confirmation request with the information to be confirmed contained on it may sign and return the confirmation without verifying that the information is correct, blank forms may be used as one way to mitigate this risk. Thus, the use of blank confirmation requests may provide a greater degree of assurance about the information confirmed. However, blank forms might result in lower response rates because additional effort may be required of the recipients; consequently, the auditor may have to perform more alternative procedures.

.20 The negative form requests the recipient to respond only if he or she disagrees with the information stated on the request. Negative confirmation requests may be used to reduce audit risk to an acceptable level when (*a*) the combined assessed level of inherent and control risk is low, (*b*) a large number of small balances is involved, and (*c*) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration. For example, in the examination of demand deposit accounts in a financial institution, it may be appropriate for an auditor to include negative confirmation requests with the customers' regular statements when the combined assessed level of inherent and control risk is low and the auditor has no reason to believe that the recipients will not consider the requests. The auditor should consider performing other substantive procedures to supplement the use of negative confirmations.

.21 Negative confirmation requests may generate responses indicating misstatements, and are more likely to do so if the auditor sends a large number of negative confirmation requests and such misstatements are widespread. The auditor should investigate relevant information provided on negative

confirmations that have been returned to the auditor to determine the effect such information may have on the audit. If the auditor's investigation of responses to negative confirmation requests indicates a pattern of misstatements, the auditor should reconsider his or her combined assessed level of inherent and control risk and consider the effect on planned audit procedures.

.22 Although returned negative confirmations may provide evidence about the financial statement assertions, unreturned negative confirmation requests rarely provide significant evidence concerning financial statement assertions other than certain aspects of the existence assertion. For example, negative confirmations may provide some evidence of the existence of third parties if they are not returned with an indication that the addressees are unknown. However, unreturned negative confirmations do not provide explicit evidence that the intended third parties received the confirmation requests and verified that the information contained on them is correct.

Prior Experience

.23 In determining the effectiveness and efficiency of employing confirmation procedures, the auditor may consider information from prior years' audits or audits of similar entities. This information includes response rates, knowledge of misstatements identified during prior years' audits, and any knowledge of inaccurate information on returned confirmations. For example, if the auditor has experienced poor response rates to properly designed confirmation requests in prior audits, the auditor may instead consider obtaining audit evidence from other sources.

Nature of Information Being Confirmed

.24 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

When designing confirmation requests, the auditor should consider the types of information respondents will be readily able to confirm, since the nature of the information being confirmed may directly affect the appropriateness of the evidence obtained as well as the response rate. For example, certain respondents' accounting systems may facilitate the confirmation of single transactions rather than of entire account balances. In addition, respondents may not be able to confirm the balances of their installment loans, but they may be able to confirm whether their payments are up-to-date, the amount of the payment, and the key terms of their loans.

.25 The auditor's understanding of the client's arrangements and transactions with third parties is key to determining the information to be confirmed. The auditor should obtain an understanding of the substance of such arrangements and transactions to determine the appropriate information to include on the confirmation request. The auditor should consider requesting confirmation of the terms of unusual agreements or transactions, such as bill and hold sales,[1] in addition to the amounts. The auditor also should consider whether there may be oral modifications to agreements, such as unusual payment terms or liberal rights of return. When the auditor believes there is a moderate or high degree of risk that there may be significant oral modifications, he or she should inquire about the existence and details of any such modifications to written agreements. One method of doing so is to confirm both the terms of the agreements and whether any oral modifications exist.

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[1] Bill and hold sales are sales of merchandise that are billed to customers before delivery and are held by the entity for the customers.

Respondent

.26 The auditor should direct the confirmation request to a third party who the auditor believes is knowledgeable about the information to be confirmed. For example, to confirm a client's oral and written guarantees with a financial institution, the auditor should direct the request to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the transactions or arrangements.

.27 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

If information about the respondent's competence, knowledge, motivation, ability, or willingness to respond, or about the respondent's objectivity and freedom from bias with respect to the audited entity[2] comes to the auditor's attention, the auditor should consider the effects of such information on designing the confirmation request and evaluating the results, including determining whether other procedures are necessary. In addition, there may be circumstances (such as for significant, unusual year-end transactions that have a material effect on the financial statements or where the respondent is the custodian of a material amount of the audited entity's assets) in which the auditor should exercise a heightened degree of professional skepticism relative to these factors about the respondent. In these circumstances, the auditor should consider whether there is sufficient basis for concluding that the confirmation request is being sent to a respondent from whom the auditor can expect the response will provide meaningful and appropriate evidence.

Performing Confirmation Procedures

.28 During the performance of confirmation procedures, the auditor should maintain control over the confirmation requests and responses. Maintaining control[3] means establishing direct communication between the intended recipient and the auditor to minimize the possibility that the results will be biased because of interception and alteration of the confirmation requests or responses.

.29 There may be situations in which the respondent, because of timeliness or other considerations, responds to a confirmation request other than in a written communication mailed to the auditor. When such responses are received, additional evidence may be required to support their validity. For example, facsimile responses involve risks because of the difficulty of ascertaining the sources of the responses. To restrict the risks associated with facsimile responses and treat the confirmations as valid audit evidence, the auditor should consider taking certain precautions, such as verifying the source and contents of a facsimile response in a telephone call to the purported sender. In addition, the auditor should consider requesting the purported sender to mail the *original* confirmation directly to the auditor. Oral confirmations should be documented in the workpapers. If the information in the oral confirmations is significant, the auditor should request the parties involved to submit written confirmation of the specific information directly to the auditor.

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[2] Section 334, *Related Parties*, paragraphs .09 and .10, provide guidance on examining related-party transactions that have been identified by the auditor.

[3] The need to maintain control does not preclude the use of internal auditors in the confirmation process. Section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, provides guidance on considering the work of internal auditors and on using internal auditors to provide direct assistance to the auditor.

.30 When using confirmation requests other than the negative form, the auditor should generally follow up with a second and sometimes a third request to those parties from whom replies have not been received.

Alternative Procedures

.31 When the auditor has not received replies to positive confirmation requests, he or she should apply alternative procedures to the nonresponses to obtain the evidence necessary to reduce audit risk to an acceptably low level. However, the omission of alternative procedures may be acceptable (*a*) when the auditor has not identified unusual qualitative factors or systematic characteristics related to the nonresponses, such as that all nonresponses pertain to year-end transactions, and (*b*) when testing for overstatement of amounts, the nonresponses in the aggregate, when projected as 100 percent misstatements to the population and added to the sum of all other unadjusted differences, would not affect the auditor's decision about whether the financial statements are materially misstated.

.32 The nature of alternative procedures varies according to the account and assertion in question. In the examination of accounts receivable, for example, alternative procedures may include examination of subsequent cash receipts (including matching such receipts with the actual items being paid), shipping documents, or other client documentation to provide evidence for the existence assertion. In the examination of accounts payable, for example, alternative procedures may include examination of subsequent cash disbursements, correspondence from third parties, or other records to provide evidence for the completeness assertion.

Evaluating the Results of Confirmation Procedures

.33 After performing any alternative procedures, the auditor should evaluate the combined evidence provided by the confirmations and the alternative procedures to determine whether sufficient evidence has been obtained about all the applicable financial statement assertions. In performing that evaluation, the auditor should consider (*a*) the reliability of the confirmations and alternative procedures; (*b*) the nature of any exceptions, including the implications, both quantitative and qualitative, of those exceptions; (*c*) the evidence provided by other procedures; and (*d*) whether additional evidence is needed. If the combined evidence provided by the confirmations, alternative procedures, and other procedures is not sufficient, the auditor should request additional confirmations or extend other tests, such as tests of details or analytical procedures.

Confirmation of Accounts Receivable

.34 For the purpose of this section, *accounts receivable* means—

a. The entity's claims against customers that have arisen from the sale of goods or services in the normal course of business, and

b. A financial institution's loans.

Confirmation of accounts receivable is a generally accepted auditing procedure. As discussed in paragraph .06, it is generally presumed that evidence obtained from third parties will provide the auditor with higher-quality audit evidence than is typically available from within the entity. Thus, there is a presumption

that the auditor will request the confirmation of accounts receivable during an audit unless one of the following is true:

- Accounts receivable are immaterial to the financial statements.
- The use of confirmations would be ineffective.[4]
- The auditor's combined assessed level of inherent and control risk is low, and the assessed level, in conjunction with the evidence expected to be provided by analytical procedures or other substantive tests of details, is sufficient to reduce audit risk to an acceptably low level for the applicable financial statement assertions. In many situations, both confirmation of accounts receivable and other substantive tests of details are necessary to reduce audit risk to an acceptably low level for the applicable financial statement assertions.

.35 An auditor who has not requested confirmations in the examination of accounts receivable should document how he or she overcame this presumption.

Effective Date

.36 This section is effective for audits of fiscal periods ending after June 15, 1992. Early application of this section is permissible.

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[4] For example, if, based on prior years' audit experience or on experience with similar engagements, the auditor concludes that response rates to properly designed confirmation requests will be inadequate, or if responses are known or expected to be unreliable, the auditor may determine that the use of confirmations would be ineffective.

AU Section 331

Inventories[*]

Source: SAS No. 1, section 331; SAS No. 43; SAS No. 67.

Issue date, unless otherwise indicated: November, 1972.

.01 Observation of inventories is a generally accepted auditing procedure. The independent auditor who issues an opinion when he has not employed them must bear in mind that he has the burden of justifying the opinion expressed. [As amended, effective for fiscal periods ending after June 15, 1992, by Statement on Auditing Standards No. 67.]

.02 The purpose of this section is to provide guidelines for the independent auditor in observing inventories. This section relates only to observation of inventories and does not deal with other important auditing procedures which generally are required for the independent auditor to satisfy himself as to these assets. [Revised, December 1991, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 67.]

Receivables

[.03–.08] [Superseded November 1991 by Statement on Auditing Standards No. 67.][1–2]

Inventories

.09 When inventory quantities are determined solely by means of a physical count, and all counts are made as of the balance-sheet date or as of a single date within a reasonable time before or after the balance-sheet date, it is ordinarily necessary for the independent auditor to be present at the time of count and, by suitable observation, tests, and inquiries, satisfy himself respecting the effectiveness of the methods of inventory-taking and the measure of reliance which may be placed upon the client's representations about the quantities and physical condition of the inventories.

.10 When the well-kept perpetual inventory records are checked by the client periodically by comparisons with physical counts, the auditor's observation procedures usually can be performed either during or after the end of the period under audit.

.11 In recent years, some companies have developed inventory controls or methods of determining inventories, including statistical sampling, which are highly effective in determining inventory quantities and which are sufficiently reliable to make unnecessary an annual physical count of each item of inventory. In such circumstances, the independent auditor must satisfy himself that the client's procedures or methods are sufficiently reliable to produce results

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[*] Title amended, effective for audits of fiscal periods ending after June 15, 1992, by Statement on Auditing Standards No. 67.

[1–2] [Superseded November 1991, by Statement on Auditing Standards No. 67.]

substantially the same as those which would be obtained by a count of all items each year. The auditor must be present to observe such counts as he deems necessary and must satisfy himself as to the effectiveness of the counting procedures used. If statistical sampling methods are used by the client in the taking of the physical inventory, the auditor must be satisfied that the sampling plan is reasonable and statistically valid, that it has been properly applied, and that the results are reasonable in the circumstances. [Revised, June 1981, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 39.]

.12 When the independent auditor has not satisfied himself as to inventories in the possession of the client through the procedures described in paragraphs .09 through .11, tests of the accounting records alone will not be sufficient for him to become satisfied as to quantities; it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions. This should be coupled with inspection of the records of any client's counts and procedures relating to the physical inventory on which the balance-sheet inventory is based.

.13 The independent auditor may be asked to audit financial statements covering the current period and one or more periods for which he had not observed or made some physical counts of prior inventories. He may, nevertheless, be able to become satisfied as to such prior inventories through appropriate procedures, such as tests of prior transactions, reviews of the records of prior counts, and the application of gross profit tests, provided that he has been able to become satisfied as to the current inventory.

Inventories Held in Public Warehouses[3]

.14 If inventories are in the hands of public warehouses or other outside custodians, the auditor ordinarily would obtain direct confirmation in writing from the custodian. If such inventories represent a significant proportion of current or total assets, to obtain reasonable assurance with respect to their existence, the auditor should apply one or more of the following procedures as he considers necessary in the circumstances.

a. Test the owner's procedures for investigating the warehouseman and evaluating the warehouseman's performance.

b. Obtain an independent accountant's report on the warehouseman's control procedures relevant to custody of goods and, if applicable, pledging of receipts, or apply alternative procedures at the warehouse to gain reasonable assurance that information received from the warehouseman is reliable.

c. Observe physical counts of the goods, if practicable and reasonable.

d. If warehouse receipts have been pledged as collateral, confirm with lenders pertinent details of the pledged receipts (on a test basis, if appropriate).

[As amended, effective after August 31, 1982, by Statement on Auditing Standards No. 43.]

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[3] See section 901 for Special Report of Committee on Auditing Procedure.

Effect on the Auditor's Report

.15 For a discussion of the circumstances relating to receivables and inventories affecting the independent auditor's report, see sections 508.24 and 508.67. [As amended, effective for periods ending on or after December 31, 1974, by Statement on Auditing Standards No. 2. Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, effective after August 1982.]

AU Section 332

Auditing Derivative Instruments, Hedging Activities, and Investments in Securities[1]

(Supersedes SAS No. 81)

Source: SAS No. 92; Auditing Standard No. 5; Auditing Standard Nos. 8–15.

Effective for audits of financial statements for fiscal years ending on or after June 30, 2001. Early application is permitted.

Applicability

.01 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

This section provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in securities[2] that are made in an entity's financial statements.[3] Those assertions[4] are classified according to five broad categories that are discussed in paragraphs 11 and 12 of Auditing Standard No. 15, *Audit Evidence*, and address the following:

a. Existence or occurrence
b. Completeness
c. Rights and obligations
d. Valuation or allocation
e. Presentation and disclosure

Derivative Instruments and Hedging Activities Included in the Scope of this Section

.02 The guidance in this section applies to derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), of all entities. This section uses the definition of derivative that is in Financial Accounting Standards Board (FASB) Statement

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[1] The AICPA will issue an Audit Guide section entitled *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (the Guide). The Guide provides practical guidance for implementing this section.

[2] Throughout the remainder of this section, the word *security* or *securities* refers to an entity's investment in a security or securities.

[3] The guidance provided in this section applies to audits of financial statements prepared in accordance with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles. Such other bases of accounting are described in section 623, *Special Reports*, paragraph .04. References in this section to generally accepted accounting principles are intended to also refer to other comprehensive bases of accounting when the reference is relevant to the basis of accounting used.

[4] Throughout the remainder of this section, the word *assertion* refers to an assertion made in an entity's financial statements.

of Financial Accounting Standards (Statement) No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended [AC section D50] (hereinafter referred to as FASB Statement No. 133). FASB Statement No. 133 addresses the accounting for derivatives that are either freestanding or embedded in contracts or agreements. For purposes of applying the guidance in this section, a derivative is a financial instrument or other contract with all three of the characteristics listed in FASB Statement No. 133, which are the following.

a. It has (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not settlement is required.

b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

.03 An entity may enter into a derivative[5] for investment purposes or to designate it as a hedge of exposure to changes in fair value (referred to as a *fair value hedge*), exposure to variability in cash flows (referred to as a *cash flow hedge*), or foreign currency exposure. The guidance in this section applies to hedging activities in which the entity designates a derivative or a nonderivative financial instrument as a hedge of exposure for which FASB Statement No. 133 permits hedge accounting.

Securities Included in the Scope of this Section

.04 The guidance in this section applies to all securities. There are two types of securities—debt securities and equity securities. This section uses the definitions of debt security and equity security that are in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* [AC section I80]. This section applies to debt and equity securities without regard to whether they are subject to the accounting requirements of FASB Statement No. 115. For example, it applies to assertions about securities accounted for under the equity method following the requirements of Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* [AC section I82].

The Need for Special Skill or Knowledge to Plan and Perform Auditing Procedures

.05 The auditor may need special skill or knowledge to plan and perform auditing procedures for certain assertions about derivatives and securities. Examples of such auditing procedures and the special skill or knowledge required include—

- Obtaining an understanding of an entity's information system for derivatives and securities, including services provided by a service

[5] To simplify the use of terminology, the remainder of this section often uses the term *derivative* to refer to both the derivative and the purpose for which the entity uses it.

organization, which may require that the auditor have special skill or knowledge with respect to computer applications when significant information about derivatives and securities is transmitted, processed, maintained, or accessed electronically.

- Identifying controls placed in operation by a service organization that provides services to an entity that are part of the entity's information system for derivatives and securities, which may require that the auditor have an understanding of the operating characteristics of entities in a certain industry.

- Understanding the application of generally accepted accounting principles for assertions about derivatives, which might require that the auditor have special knowledge because of the complexity of those principles. In addition, a derivative may have complex features that require the auditor to have special knowledge to evaluate the measurement and disclosure of the derivative in conformity with generally accepted accounting principles. For example, features embedded in contracts or agreements may require separate accounting as a derivative, and complex pricing structures may increase the complexity of the assumptions used in estimating the fair value of a derivative.

- Understanding the determination of the fair values of derivatives and securities, including the appropriateness of various types of valuation models and the reasonableness of key factors and assumptions, which may require knowledge of valuation concepts.

- Assessing inherent risk and control risk for assertions about derivatives used in hedging activities, which may require an understanding of general risk management concepts and typical asset/liability management strategies.

.06 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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.

Audit Risk and Materiality

.07 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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. The auditor may also consider the work performed by the entity's internal auditors in designing procedures. Guidance on considering the work performed by internal auditors is found in section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.

Inherent Risk Assessment

.08 The inherent risk for an assertion about a derivative or security is its susceptibility to a material misstatement, assuming there are no related controls. Examples of considerations that might affect the auditor's assessment of inherent risk for assertions about a derivative or security include the following.

- *Management's objectives*. Accounting requirements based on management's objectives may increase the inherent risk for certain assertions. For example, in response to management's objective of minimizing the risk of loss from changes in market conditions, the entity may enter into derivatives as hedges. The use of hedges is subject to the risk that market conditions will change in a manner other than expected when the hedge was implemented so that the hedge is no longer effective. That increases the inherent risk for certain assertions about the derivatives because in such circumstances continued application of hedge accounting would not be in conformity with generally accepted accounting principles.
- *The complexity of the features of the derivative or security*. The complexity of the features of the derivative or security may increase the complexity of measurement and disclosure considerations required by generally accepted accounting principles. For example, interest payments on a structured note may be based on two or more factors, such as one or more interest rates and the market price of certain equity securities. A formula may dictate the interaction of the factors, such as a prescribed interest rate less a multiple of another rate. The number and interaction of the factors may increase the inherent risk for assertions about the fair value of the note.
- *Whether the transaction that gave rise to the derivative or security involved the exchange of cash*. Derivatives that do not involve an initial exchange of cash are subject to an increased risk that they will not be identified for valuation and disclosure considerations. For example, a foreign exchange forward contract that is not recorded at its inception because the entity does not pay cash to enter into the contract is subject to an increased risk that it will not be identified for subsequent adjustment to fair value. Similarly, a stock warrant for a traded security that is donated to an entity is subject to an increased risk that it will not be identified for initial or continuing measurement at fair value.
- *The entity's experience with the derivative or security*. An entity's inexperience with a derivative or security increases the inherent risk for assertions about it. For example, under a new arrangement, an entity may pay a small deposit to enter into a futures contract for foreign currency to pay for purchases from an overseas supplier. The entity's inexperience with such derivatives may lead it to incorrectly account for the deposit, such as treating it as inventory cost, thereby increasing the risk that the contract will not be identified for subsequent adjustment to fair value.
- *Whether a derivative is freestanding or an embedded feature of an agreement*. Embedded derivatives are less likely to be identified by management, which increases the inherent risk for certain assertions. For example, an option to convert the principal outstanding under a loan agreement into equity securities is less likely to

be identified for valuation and disclosure considerations if it is a clause in a loan agreement than if it is a freestanding agreement. Similarly, a structured note may include a provision for payments related to changes in a stock index or commodities prices that requires separate accounting.

- *Whether external factors affect the assertion*. Assertions about derivatives and securities may be affected by a variety of risks related to external factors, such as—
  - — *Credit risk*, which exposes the entity to the risk of loss as a result of the issuer of a debt security or the counterparty to a derivative failing to meet its obligation.
  - — *Market risk*, which exposes the entity to the risk of loss from adverse changes in market factors that affect the fair value of a derivative or security, such as interest rates, foreign exchange rates, and market indexes for equity securities.
  - — *Basis risk*, which exposes the entity to the risk of loss from ineffective hedging activities. Basis risk is the difference between the fair value (or cash flows) of the hedged item and the fair value (or cash flows) of the hedging derivative. The entity is subject to the risk that fair values (or cash flows) will change so that the hedge will no longer be effective.
  - — *Legal risk*, which exposes the entity to the risk of loss from a legal or regulatory action that invalidates or otherwise precludes performance by one or both parties to the derivative or security.

    Following are examples of how changes in external factors can affect assertions about derivatives and securities.

  - — The increase in credit risk associated with amounts due under debt securities issued by entities that operate in declining industries increases the inherent risk for valuation assertions about those securities.
  - — Significant changes in and the volatility of general interest rates increase the inherent risk for the valuation of derivatives whose value is significantly affected by interest rates.
  - — Significant changes in default rates and prepayments increase the inherent risk for the valuation of retained interests in a securitization.
  - — The fair value of a foreign currency forward contract will be affected by changes in the exchange rate, and the fair value of a put option for an available-for-sale security will be affected by changes in the fair value of the underlying security.
- *The evolving nature of derivatives and the applicable generally accepted accounting principles*. As new forms of derivatives are developed, interpretive accounting guidance for them may not be issued until after the derivatives are broadly used in the marketplace. In addition, generally accepted accounting principles for derivatives may be subject to frequent interpretation by various standard-setting bodies. Evolving interpretative guidance and its

applicability increase the inherent risk for valuation and other assertions about existing forms of derivatives.

- *Significant reliance on outside parties*. An entity that relies on external expertise may be unable to appropriately challenge the specialist's methodology or assumptions. This may occur, for example, when a valuation specialist values a derivative.
- *Generally accepted accounting principles may require developing assumptions about future conditions*. As the number and subjectivity of those assumptions increase, the inherent risk of material misstatement increases for certain assertions. For example, the inherent risk for valuation assertions based on assumptions about debt securities whose value fluctuates with changes in prepayments (for example, interest-only strips) increases as the expected holding period lengthens. Similarly, the inherent risk for assertions about cash flow hedges fluctuates with the subjectivity of the assumptions about probability, timing, and amounts of future cash flows.

Control Risk Assessment

Obtaining an Understanding of Internal Control to Plan the Audit

.09 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, requires the auditor to obtain an understanding of internal control that will enable the auditor to—

a. Identify the types of potential misstatement of the assertions.

b. Consider factors that affect the risk that the misstatements would be material to the financial statements.

c. Design tests of controls, when applicable.

d. Design substantive tests.

[Revised, May 2001, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

.10 Controls should be related to management's objectives for financial reporting, operations, and compliance.[6] For example, to achieve its objectives, management of an entity with extensive derivatives transactions may implement controls that call for—

a. Monitoring by a control staff that is fully independent of derivatives activities.

b. Derivatives personnel to obtain, prior to exceeding limits, at least oral approval from members of senior management who are independent of derivatives activities.

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[6] The AICPA issued an Audit Guide concurrent with this section entitled *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (the Guide). Chapter 5 of the Guide, "Control Risk Assessment," provides sample control objectives for derivatives, hedging activities, and securities which may be useful to auditors in assessing control risk for relevant assertions. Additionally, in 1996, The Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued *Internal Control Issues in Derivatives Usage: An Information Tool for Considering the COSO Internal Control—Integrated Framework in Derivatives Applications*. Although the document precedes FASB Statement No. 133, its guidance may be useful to entities in developing controls over derivatives transactions and to auditors in assessing control risk for assertions about those transactions.

c. Senior management to properly address limit excesses and divergences from approved derivatives strategies.

d. The accurate transmittal of derivatives positions to the risk measurement systems.

e. The performance of appropriate reconciliations to ensure data integrity across the full range of derivatives, including any new or existing derivatives that may be monitored apart from the main processing networks.

f. Derivatives traders, risk managers, and senior management to define constraints on derivatives activities and justify identified excesses.

g. Senior management, an independent group, or an individual that management designates to perform a regular review of the identified controls and financial results of the derivatives activities to determine whether controls are being effectively implemented and the entity's business objectives and strategies are being achieved.

h. A review of limits in the context of changes in strategy, risk tolerance of the entity, and market conditions.

.11 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The extent of the understanding of internal control over derivatives and securities obtained by the auditor depends on how much information the auditor needs to identify the types of potential misstatements, consider factors that affect the risk of material misstatement, design tests of controls when applicable, and design substantive tests. The understanding obtained may include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements. It may encompass controls placed in operation by the entity and by service organizations whose services are part of the entity's information system. 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. Following the guidance in section 324, *Service Organizations*, a service organization's services are part of an entity's information system for derivatives and securities if they affect any of the following:

a. How the entity's derivatives and securities transactions are initiated.

b. The accounting records, supporting information, and specific accounts in the financial statements involved in the processing and reporting of the entity's derivatives and securities transactions

c. The accounting processing involved from the initiation of those transactions to their inclusion in the financial statements, including electronic means (such as computers and electronic data interchange) used to transmit, process, maintain, and access information

d. The process the entity uses to report information about derivatives and securities transactions in its financial statements, including significant accounting estimates and disclosures

[Revised, May 2001, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 94.]

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]

Note: When performing an integrated audit of financial statements and internal control over financial reporting, paragraph 39 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, states "[t]he 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." Therefore, in an integrated audit of financial statements and internal control over financial reporting, if there are relevant assertions related to the company's investment in derivatives and securities, the auditor's understanding of controls should include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements and should encompass controls placed in operation by the entity and service organizations whose services are part of the entity's information system.

.12 Examples of a service organization's services that would be part of an entity's information system include—

- The initiation of the purchase or sale of equity securities by a service organization acting as investment adviser or manager.
- Services that are ancillary to holding[7] an entity's securities such as—
  - — Collecting dividend and interest income and distributing that income to the entity.
  - — Receiving notification of corporate actions.
  - — Receiving notification of security purchase and sale transactions.
  - — Receiving payments from purchasers and disbursing proceeds to sellers for security purchase and sale transactions.
  - — Maintaining records of securities transactions for the entity.
- A pricing service providing fair values of derivatives and securities through paper documents or electronic downloads that the entity uses to value its derivatives and securities for financial statement reporting.

.13 Examples of a service organization's services that would not be part of an entity's information system are the following:

- The execution by a securities broker of trades that are initiated by either the entity or its investment adviser
- The holding of an entity's securities

.14 An auditor who needs information about the nature of a service organization's services that are part of an entity's information system for derivatives and securities transactions, or its controls over those services, to plan the audit may be able to gather the information from a variety of sources, such as the following:

- User manuals
- System overviews
- Technical manuals

[7] In this section, maintaining custody of securities, either in physical or electronic form, is referred to as *holding* securities, and performing ancillary services is referred to as *servicing* securities.

- The contract between the entity and the service organization
- Reports by auditors,[8] internal auditors, or regulatory authorities on the information system and other controls placed in operation by a service organization
- Inquiry or observation of personnel at the entity or at the service organization

In addition, if the services and the service organization's controls over those services are highly standardized, information about the service organization's services, or its controls over those services, obtained through the auditor's prior experience with the service organization may be helpful in planning the audit.

Assessing Control Risk

.15 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

After obtaining the understanding of internal control over derivatives and securities transactions, the auditor should assess control risk for the related assertions. Guidance on that assessment is found in Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

.16 If the auditor plans to assess control risk below the maximum for one or more assertions about derivatives and securities, the auditor should identify specific controls relevant to the assertions that are likely to prevent or detect material misstatements and that have been placed in operation by either the entity or the service organization, and gather evidential matter about their operating effectiveness. Evidential matter about the operating effectiveness of a service organization's controls may be gathered through tests performed by the auditor or by an auditor engaged by either the auditor or the service organization—

a. As part of an engagement in which a service auditor reports on the controls placed in operation by the service organization and the operating effectiveness of those controls, as described in section 324.

b. An agreed-upon procedures engagement.[9]

c. To work under the direction of the auditor of the entity's financial statements.

Confirmations of balances or transactions from a service organization do not provide evidential matter about its controls.

.17 The auditor should consider the size of the entity, the entity's organizational structure, the nature of its operations, the types, frequency, and complexity of its derivatives and securities transactions, and its controls over those transactions in designing auditing procedures for assertions about derivatives and securities. For example, if the entity has a variety of derivatives and securities that are reported at fair value estimated using valuation models, the auditor may be able to reduce the substantive procedures for valuation assertions by gathering evidential matter about the controls over the design and

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[8] Section 324 provides guidance on auditors' reports on controls placed in operation by a service organization and the operating effectiveness of those controls.

[9] AT section 201, *Agreed-Upon Procedures Engagements*, provides guidance on applying agreed-upon procedures to controls. [Footnote revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

use of the models (including the significant assumptions) and evaluating their operating effectiveness.

.18 In some circumstances, it may not be practicable or possible for the auditor to reduce audit risk to an acceptable level without identifying controls placed in operation by the entity or a service organization and gathering evidential matter about the operating effectiveness of those controls. For example, if the entity has a large number of derivatives or securities transactions, the auditor likely would be unable to reduce audit risk to an acceptable level for assertions about the occurrence of earnings on those securities, including gains and losses from sales, without identifying controls over the authorization, recording, custody, and segregation of duties for those transactions and gathering evidential matter about their operating effectiveness.[10]

Designing Substantive Procedures Based on Risk Assessments

.19 The auditor should use the assessed levels of inherent risk and control risk for assertions about derivatives and securities to determine the nature, timing, and extent of the substantive procedures to be performed to detect material misstatements of the financial statement assertions. Some substantive procedures address more than one assertion about a derivative or security. Whether one or a combination of substantive procedures should be used to address an assertion depends on the auditor's assessment of the inherent and control risk associated with it as well as the auditor's judgment about a procedure's effectiveness. Paragraphs .21 through .58 provide examples of substantive procedures that address assertions about derivatives and securities. In addition, the auditor should consider whether the results of other audit procedures conflict with management's assertions about derivatives and securities. The auditor should consider the impact of any such identified matters on management's assertions about derivatives and securities. Additionally, the auditor should consider the impact of such matters on the sufficiency of the evidential matter evaluated by the auditor in support of the assertions.

.20 The provision by a service organization of services that are part of an entity's information system may affect the nature, timing, and extent of the auditor's substantive procedures for assertions about derivatives and securities in a variety of ways. Following are examples of such services and how they may affect the nature, timing, and extent of the auditor's substantive procedures.

- Supporting documentation, such as derivative contracts and securities purchases and sales advices, may be located at the service organization's facilities. As a result, either the auditor of the entity's financial statements, an auditor working under the direction of that auditor, or an auditor engaged by the service organization may need to visit the facilities to inspect the documentation.
- Data processors, investment advisers, holders of securities, recordkeepers, and other service organizations may electronically transmit, process, maintain, or access significant information about an entity's securities. In such situations, it may not be practicable or possible for the auditor to reduce audit risk to an acceptable level without identifying controls placed in operation by the service organization or the entity and gathering evidential matter about the operating effectiveness of those controls.

[10] See footnote 6.

- Service organizations may initiate securities transactions for an entity and hold and service the securities. In determining the level of detection risk for substantive tests, the auditor should consider whether there is a segregation of duties and other controls for the services provided. Examples include—
  - — When one service organization initiates transactions as an investment adviser and another service organization holds and services those securities, the auditor may corroborate the information provided by the two organizations. For example, the auditor may confirm holdings with the holder of the securities and apply other substantive tests to transactions reported by the entity based on information provided by the investment adviser. Depending on the facts and circumstances, the auditor also may confirm transactions or holdings with the investment adviser and review the reconciliation of differences. Paragraph .24 provides additional guidance on the auditor's considerations.
  - — If one service organization initiates transactions as an investment adviser and also holds and services the securities, all of the information available to the auditor is based on the service organization's information. The auditor may be unable to sufficiently limit audit risk without obtaining evidential matter about the operating effectiveness of one or more of the service organization's controls. An example of such controls is establishing independent departments that provide the investment advisory services and the holding and servicing of securities, then reconciling the information about the securities that is provided by each department.

Financial Statement Assertions

Existence or Occurrence

.21 Existence assertions address whether the derivatives and securities reported in the financial statements through recognition or disclosure exist at the date of the statement of financial position. Occurrence assertions address whether derivatives and securities transactions reported in the financial statements, as a part of earnings, other comprehensive income, or cash flows or through disclosure, occurred. Paragraph .19 provides guidance on the auditor's determination of the nature, timing, and extent of substantive procedures to be performed. Examples of substantive procedures for existence or occurrence assertions about derivatives and securities include—

- Confirmation with the issuer of the security.
- Confirmation with the holder of the security, including securities in electronic form, or with the counterparty to the derivative.[11]

[11] Section 330, provides guidance to auditors in using confirmations as substantive tests of financial statement assertions. Confirmations may be used as a substantive test of various financial statement assertions about derivatives and securities. For example, a confirmation may be designed to—

- Obtain information about valuation assertions or assumptions underlying valuations.
- Determine whether there are any side agreements that affect assertions about the entity's rights and obligations associated with a transaction, such as an agreement to repurchase securities sold or an agreement to pledge securities as collateral for a loan.
- Determine whether the holder of the entity's securities agrees to deliver the securities reported or their value when required by the entity.

- Confirmation of settled transactions with the broker-dealer or counterparty.
- Confirmation of unsettled transactions with the broker-dealer or counterparty.
- Physical inspection of the security or derivative contract.
- Reading executed partnership or similar agreements.
- Inspecting underlying agreements and other forms of supporting documentation, in paper or electronic form, for the following:
  - — Amounts reported
  - — Evidence that would preclude the sales treatment of a transfer
  - — Unrecorded repurchase agreements
- Inspecting supporting documentation for subsequent realization or settlement after the end of the reporting period.
- Performing analytical procedures.[12] For example, the absence of a material difference from an expectation that interest income will be a fixed percentage of a debt security based on the effective interest rate determined when the entity purchased the security provides evidence about existence of the security.

Completeness

.22 Completeness assertions address whether all of the entity's derivatives and securities are reported in the financial statements through recognition or disclosure. They also address whether all derivatives and securities transactions are reported in the financial statements as a part of earnings, other comprehensive income, or cash flows or through disclosure. The extent of substantive procedures for completeness may properly vary in relation to the assessed level of control risk. In addition, the auditor should consider that since derivatives may not involve an initial exchange of tangible consideration, it may be difficult to limit audit risk for assertions about the completeness of derivatives to an acceptable level with an assessed level of control risk at the maximum. Paragraph .19 provides guidance on the auditor's determination of the nature, timing, and extent of substantive procedures to be performed. Examples of substantive procedures for completeness assertions about derivatives and securities are—

- Requesting the counterparty to a derivative or the holder of a security to provide information about it, such as whether there are any side agreements or agreements to repurchase securities sold.
- Requesting counterparties or holders who are frequently used, but with whom the accounting records indicate there are presently no derivatives or securities, to state whether they are counterparties to derivatives with the entity or holders of its securities.[13]
- Inspecting financial instruments and other agreements to identify embedded derivatives.

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[12] Section 329, provides guidance to auditors in using analytical procedures as substantive tests.

[13] Section 330.17 discusses the blank form of positive confirmation in which the auditor does not state the amount or other information but instead asks the respondent to provide information.

- Inspecting documentation in paper or electronic form for activity subsequent to the end of the reporting period.
- Performing analytical procedures. For example, a difference from an expectation that interest expense is a fixed percentage of a note based on the interest provisions of the underlying agreement may indicate the existence of an interest rate swap agreement.
- Comparing previous and current account detail to identify assets that have been removed from the accounts and testing those items further to determine that the criteria for sales treatment have been met.
- Reading other information, such as minutes of meetings of the board of directors or finance, asset/liability, investment, or other committees.

.23 One of the characteristics of derivatives is that they may involve only a commitment to perform under a contract and not an initial exchange of tangible consideration. Therefore, auditors designing tests related to the completeness assertion should not focus exclusively on evidence relating to cash receipts and disbursements. When testing for completeness, auditors should consider making inquiries, inspecting agreements, and reading other information, such as minutes of meetings of the board of directors or finance, asset/liability, investment, or other committees. Auditors should also consider making inquiries about aspects of operating activities that might present risks hedged using derivatives. For example, if the entity conducts business with foreign entities, the auditor should inquire about any arrangements the entity has made for purchasing foreign currency. Similarly, if an entity is in an industry in which commodity contracts are common, the auditor should inquire about any commodity contracts with fixed prices that run for unusual durations or involve unusually large quantities. The auditor also should consider inquiring as to whether the entity has converted interest-bearing debt from fixed to variable, or vice versa, using derivatives.

.24 Derivatives may not involve an initial exchange of tangible consideration, as discussed in paragraphs .22 and .23. If one or more service organizations provide services that are part of the entity's information system for derivatives, the auditor may be unable to sufficiently limit audit risk for assertions about the completeness of derivatives without obtaining evidential matter about the operating effectiveness of controls at one or more of the service organizations. Since the auditor's concern is that derivatives that do not require an initial exchange of tangible consideration may not have been recorded, testing reconciliations of information provided by two or more of the service organizations as discussed in paragraph .20 of this section may not sufficiently limit audit risk for assertions about the completeness of derivatives.

Rights and Obligations

.25 Assertions about rights and obligations address whether the entity has the rights and obligations associated with derivatives and securities, including pledging arrangements, reported in the financial statements. Paragraph .19 provides guidance on the auditor's determination of the nature, timing, and extent of substantive procedures to be performed. Examples of substantive procedures for assertions about rights and obligations associated with derivatives and securities are—

- Confirming significant terms with the counterparty to a derivative or the holder of a security, including the absence of any side agreements.

- Inspecting underlying agreements and other forms of supporting documentation, in paper or electronic form.
- Considering whether the findings of other auditing procedures, such as reviewing minutes of meetings of the board of directors and reading contracts and other agreements, provide evidence about rights and obligations, such as pledging of securities as collateral or selling securities with a commitment to repurchase them.

Valuation

.26 Assertions about the valuation of derivatives and securities address whether the amounts reported in the financial statements through measurement or disclosure were determined in conformity with generally accepted accounting principles. Tests of valuation assertions should be designed according to the valuation method used for the measurement or disclosure. Generally accepted accounting principles may require that a derivative or security be valued based on cost, the investee's financial results, or fair value. They also may require disclosures about the value of a derivative or security and specify that impairment losses should be recognized in earnings prior to their realization. Also, generally accepted accounting principles for securities may vary depending on the type of security, the nature of the transaction, management's objectives related to the security, and the type of entity. Procedures for evaluating management's consideration of the need to recognize impairment losses are discussed in paragraphs .47 and .48 of this section.

.27 *Valuation Based on Cost.* Procedures to obtain evidence about the cost of securities may include inspection of documentation of the purchase price, confirmation with the issuer or holder, and testing discount or premium amortization, either by recomputation or analytical procedures. The auditor should evaluate management's conclusion about the need to recognize an impairment loss for a decline in the security's fair value below its cost that is other than temporary.

.28 *Valuation Based on an Investee's Financial Results.* For valuations based on an investee's financial results, including but not limited to the equity method of accounting, the auditor should obtain sufficient evidence in support of the investee's financial results. The auditor should read available financial statements of the investee and the accompanying audit report, if any. Financial statements of the investee that have been audited by an auditor whose report is satisfactory, for this purpose,[14] to the investor's auditor may constitute sufficient evidential matter.

.29 If in the auditor's judgment additional evidential matter is needed, the auditor should perform procedures to gather such evidence. For example, the auditor may conclude that additional evidential matter is needed because of significant differences in fiscal year-ends, significant differences in accounting principles, changes in ownership, changes in conditions affecting the use of the equity method, or the materiality of the investment to the investor's financial position or results of operations. Examples of procedures the auditor may perform are reviewing information in the investor's files that relates to the investee such as investee minutes and budgets and cash flows information about the investee and making inquiries of investor management about the investee's financial results.

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[14] In determining whether the report of another auditor is satisfactory for this purpose, the auditor may consider performing procedures such as making inquiries as to the professional reputation and standing of the other auditor, visiting the other auditor and discussing the audit procedures followed and the results thereof, and reviewing the audit program and/or working papers of the other auditor.

.30 If the investee's financial statements are not audited, or if the investee auditor's report is not satisfactory to the investor's auditor for this purpose, the investor's auditor should apply, or should request that the investor arrange with the investee to have another auditor apply, appropriate auditing procedures to such financial statements, considering the materiality of the investment in relation to the financial statements of the investor.

.31 If the carrying amount of the security reflects factors that are not recognized in the investee's financial statements or fair values of assets that are materially different from the investee's carrying amounts, the auditor should obtain sufficient evidence in support of these amounts. Paragraphs .35 through .46 of this section provide guidance on audit evidence that may be used to corroborate assertions about the fair value of derivatives and securities, and paragraphs .47 and .48 provide guidance on procedures for evaluating management's consideration of the need to recognize impairment losses.

.32 There may be a time lag in reporting between the date of the financial statements of the investor and that of the investee. A time lag in reporting should be consistent from period to period. If a time lag between the date of the entity's financial statements and those of the investee has a material effect on the entity's financial statements, the auditor should determine whether the entity's management has properly considered the lack of comparability. The effect may be material, for example, because the time lag is not consistent with the prior period in comparative statements or because a significant transaction occurred during the time lag. If a change in time lag occurs that has a material effect on the investor's financial statements, an explanatory paragraph should be added to the auditor's report because of the change in reporting period.[15]

.33 The auditor should evaluate management's conclusion about the need to recognize an impairment loss for a decline in the security's fair value below its carrying amount that is other than temporary. In addition, with respect to subsequent events and transactions of the investee occurring after the date of the investee's financial statements but before the date of the investor auditor's report, the auditor should read available interim financial statements of the investee and make appropriate inquiries of the investor to identify subsequent events and transactions that are material to the investor's financial statements. Such events or transactions of the type contemplated in section 560, *Subsequent Events*, paragraphs .05-.06), should be disclosed in the notes to the investor's financial statements and (where applicable) labeled as unaudited information. For the purpose of recording the investor's share of the investee's results of operations, recognition should be given to events or transactions of the type contemplated in section 560.03.

.34 Evidence relating to material transactions between the entity and the investee should be obtained to evaluate (*a*) the propriety of the elimination of unrealized profits and losses on transactions between the entity and the investee that is required when the equity method of accounting is used to account for an investment under generally accepted accounting principles and (*b*) the adequacy of disclosures about material related party transactions.

.35 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Valuation Based on Fair Value. The auditor should obtain evidence supporting management's assertions about the fair value of derivatives and securities measured or disclosed at fair value. The method for determining fair value may be

[15] See section 508, *Reports on Audited Financial Statements*, paragraphs .16–.18.

specified by generally accepted accounting principles and may vary depending on the industry in which the entity operates or the nature of the entity. Such differences may relate to the consideration of price quotations from inactive markets and significant liquidity discounts, control premiums, and commissions and other costs that would be incurred to dispose of the derivative or security. The auditor should determine whether generally accepted accounting principles specify the method to be used to determine the fair value of the entity's derivatives and securities and evaluate whether the determination of fair value is consistent with the specified valuation method. Paragraphs .35 through .46 of this section provide guidance on audit evidence that may be used to support assertions about fair value; that guidance should be considered in the context of specific accounting requirements. If the determination of fair value requires the use of estimates, the auditor should consider the guidance in section 342, *Auditing Accounting Estimates*. 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.

.36 Quoted market prices for derivatives and securities listed on national exchanges or over-the-counter markets are available from sources such as financial publications, the exchanges, the National Association of Securities Dealers Automated Quotations System (NASDAQ), or pricing services based on sources such as those. Quoted market prices obtained from those sources are generally considered to provide sufficient evidence of the fair value of the derivatives and securities.

.37 For certain other derivatives and securities, quoted market prices may be obtained from broker-dealers who are market makers in them or through the National Quotation Bureau. However, using such a price quote to test valuation assertions may require special knowledge to understand the circumstances in which the quote was developed. For example, quotations published by the National Quotation Bureau may not be based on recent trades and may only be an indication of interest and not an actual price for which a counterparty will purchase or sell the underlying derivative or security.

.38 If quoted market prices are not available for the derivative or security, estimates of fair value frequently can be obtained from broker-dealers or other third-party sources based on proprietary valuation models or from the entity based on internally or externally developed valuation models (for example, the Black-Scholes option pricing model). The auditor should understand the method used by the broker-dealer or other third-party source in developing the estimate, for example, whether a pricing model or a cash flow projection was used. The auditor may also determine that it is necessary to obtain estimates from more than one pricing source. For example, this may be appropriate if either of the following occurs.

- The pricing source has a relationship with an entity that might impair its objectivity, such as an affiliate or a counterparty involved in selling or structuring the product.
- The valuation is based on assumptions that are highly subjective or particularly sensitive to changes in the underlying circumstances.

.39 For fair-value estimates obtained from broker-dealers and other third-party sources, the auditor should consider the applicability of the guidance in section 336 or section 324. The auditor's decision about whether such guidance is applicable and which guidance is applicable will depend on the circumstances. The guidance in section 336 may be applicable if the third-party source derives the fair value of the derivative or security by using modeling or similar

techniques. If the entity uses a pricing service to obtain prices of securities and derivatives, the guidance in section 324 may be appropriate.

.40 If the derivative or security is valued by the entity using a valuation model, the auditor does not function as an appraiser and is not expected to substitute his or her judgment for that of the entity's management.[16] Examples of valuation models include the present value of expected future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.

The auditor should obtain evidence supporting management's assertions about fair value determined using a model by performing procedures such as—

- Assessing the reasonableness and appropriateness of the model. The auditor should determine whether the valuation model is appropriate for the derivative or security to which it is applied and whether the assumptions used are reasonable and appropriately supported. Estimates of expected future cash flows, for example, to determine the fair value of debt securities should be based on reasonable and supportable assumptions. The evaluation of the appropriateness of valuation models and each of the assumptions used in the models may require considerable judgment and knowledge of valuation techniques, market factors that affect value, and actual and expected market conditions, particularly in relation to similar derivatives and securities that are traded. Accordingly, the auditor may consider it necessary to involve a specialist in assessing the model.
- Calculating the value, for example using a model developed by the auditor or by a specialist engaged by the auditor, to develop an independent expectation to corroborate the reasonableness of the value calculated by the entity.
- Comparing the fair value with subsequent or recent transactions.

However, a valuation model should not be used to determine fair value when generally accepted accounting principles require that the fair value of a security be determined using quoted market prices.

.41 Evaluating evidential matter for assertions about derivatives and securities may require the auditor to use considerable judgment. That may be because the assertions, especially those about valuation, are based on highly subjective assumptions or are particularly sensitive to changes in the underlying circumstances. Valuation assertions may be based on assumptions about the occurrence of future events for which expectations are difficult to develop or on assumptions about conditions expected to exist over a long period; for example, default rates or prepayment rates. Accordingly, competent persons could reach different conclusions about estimates of fair values or estimates of ranges of fair values.

.42 Considerable judgment may also be required in evaluating evidential matter for assertions based on features of the derivative or security and applicable accounting principles, including underlying criteria such as for hedge accounting, that are extremely complex. For example, determining the fair value of a structured note may require consideration of a variety of features of the

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[16] Independence Standards Board Interpretation 99-1, *FAS 133 Assistance*, provides guidance to auditors of public companies on services an auditor may provide management to assist with the application of FASB Statement No. 133 that would and would not impair the auditor's independence. Ethics Interpretation 101-3, *Performance of Other Services* [ET section 101.05], provides general guidance to auditors of all entities on the effect of nonattest services on the auditor's independence.

note that react differently to changes in economic conditions. In addition, one or more other derivatives may be designated to hedge changes in cash flows under the note. Evaluating evidential matter to support the fair value of the note, the determination of whether the hedge is highly effective, and the allocation of changes in fair value to earnings and other comprehensive income may require considerable judgment.

.43 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

In situations requiring considerable judgment, the auditor should consider the guidance in—

a. Section 342 on obtaining and evaluating sufficient appropriate evidential matter to support significant accounting estimates.

b. Section 336 on the use of the work of a specialist in performing substantive procedures.

.44 Negotiable securities, real estate, chattels, or other property is often assigned as collateral for debt securities. If the collateral is an important factor in evaluating the fair value and collectibility of the security, the auditor should obtain evidence regarding the existence, fair value, and transferability of such collateral as well as the investor's rights to the collateral.

.45 Generally accepted accounting principles may specify how to account for unrealized appreciation and depreciation in the fair value of the entity's derivatives and securities. For example, generally accepted accounting principles require the entity to report a change in the unrealized appreciation or depreciation in the fair value of—

- A derivative that is designated as a fair value hedge in earnings, with disclosure of the ineffective portion of the hedge.
- A derivative that is designated as a cash flow hedge in two components, with the ineffective portion reported in earnings and the effective portion reported in other comprehensive income.
- A derivative that was previously designated as a hedge but is no longer highly effective, or a derivative that is not designated as a hedge, in earnings.
- An available-for-sale security in other comprehensive income.

Generally accepted accounting principles may also require the entity to reclassify amounts from accumulated other comprehensive income to earnings. For example, such reclassifications may be required because a hedged transaction is determined to no longer be probable of occurring, a hedged forecasted transaction affects earnings for the period, or a decline in fair value is determined to be other than temporary.

.46 The auditor should evaluate management's conclusion about the need to recognize in earnings an impairment loss for a decline in fair value that is other than temporary as discussed in paragraphs .47 and .48 of this section. The auditor should also gather evidential matter to support the amount of unrealized appreciation or depreciation in the fair value of a derivative that is recognized in earnings or other comprehensive income or that is disclosed because of the ineffectiveness of a hedge. That requires an understanding of the methods used to determine whether the hedge is highly effective and to determine the ineffective portion of the hedge.

.47 *Impairment Losses*. Regardless of the valuation method used, generally accepted accounting principles might require recognizing in earnings an

impairment loss for a decline in fair value that is other than temporary. Determinations of whether losses are other than temporary often involve estimating the outcome of future events. Accordingly, judgment is required in determining whether factors exist that indicate that an impairment loss has been incurred at the end of the reporting period. These judgments are based on subjective as well as objective factors, including knowledge and experience about past and current events and assumptions about future events. The following are examples of such factors.

- Fair value is significantly below cost and—
  - — The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
  - — The decline has existed for an extended period of time.
  - — Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.

.48 The auditor should evaluate (*a*) whether management has considered relevant information in determining whether factors such as those listed in paragraph .47 exist and (*b*) management's conclusions about the need to recognize an impairment loss. That evaluation requires the auditor to obtain evidence about such factors that tend to corroborate or conflict with management's conclusions. When the entity has recognized an impairment loss, the auditor should gather evidence supporting the amount of the impairment adjustment recorded and determine whether the entity has appropriately followed generally accepted accounting principles.

Presentation and Disclosure

.49 Assertions about presentation and disclosure address whether the classification, description, and disclosure of derivatives and securities in the entity's financial statements are in conformity with generally accepted accounting principles. The auditor should evaluate whether the presentation and disclosure of derivatives and securities are in conformity with generally accepted accounting principles. As noted in section 411, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles, paragraph .04, the auditor's opinion as to whether financial statements are presented in conformity with generally accepted accounting principles should be based on the auditor's judgement as to whether—

a. The accounting principles selected and applied have general acceptance.

b. The accounting principles are appropriate in the circumstances.

c. The financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation.

d. The information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed.

e. The financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.

[Title of section 411 amended, effective for reports issued or reissued on or after June 30, 2001, by Statement on Auditing Standards No. 93.]

.50 For some derivatives and securities, generally accepted accounting principles may prescribe presentation and disclosure requirements. For example—

- Whether changes in the fair value of derivatives used to hedge risks are required to be reported as a component of earnings or other comprehensive income depends on whether they are intended to hedge the risk of changes in the fair value of assets and liabilities or changes in expected future cash flows and on the degree of effectiveness of the hedge.
- Certain securities are required to be classified into categories according to management's intent and ability, such as held-to-maturity.
- Specific information is required to be disclosed about derivatives and securities.

.51 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

In evaluating the adequacy of presentation and disclosure, the auditor should consider the form, arrangement, and content of the financial statements and their notes, including, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts reported. The auditor should compare the presentation and disclosure with the requirements of generally accepted accounting principles. (See paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*.)

Additional Considerations About Hedging Activities

.52 To account for a derivative as a hedge, generally accepted accounting principles require management at the inception of the hedge to designate the derivative as a hedge and contemporaneously formally document[17] the hedging relationship, the entity's risk management objective and strategy for undertaking the hedge, and the method of assessing the effectiveness of the hedge. In addition, to qualify for hedge accounting, generally accepted accounting principles require that management have an expectation, both at the inception of the hedge and on an ongoing basis, that the hedging relationship will be highly effective in achieving the hedging strategy.[18]

.53 The auditor should gather evidential matter to determine whether management complied with the hedge accounting requirements of generally

[17] FASB Statement No. 133 requires formal documentation of prescribed aspects of hedging relationships at the inception of the hedge.

[18] See section 508, *Reports on Audited Financial Statements*, paragraphs .16–.18.

accepted accounting principles, including designation and documentation requirements. In addition, the auditor should gather evidential matter to support management's expectation at the inception of the hedge that the hedging relationship will be highly effective and its periodic assessment of the ongoing effectiveness of the hedging relationship as required by generally accepted accounting principles.

.54 When the entity designates a derivative as a fair value hedge, generally accepted accounting principles require that the entity adjust the carrying amount of the hedged item for the change in the hedged item's fair value that is attributable to the hedged risk. The auditor should gather evidential matter supporting the recorded change in the hedged item's fair value that is attributable to the hedged risk. Additionally, the auditor should gather evidential matter to determine whether management has properly applied generally accepted accounting principles to the hedged item.

.55 For a cash flow hedge of a forecasted transaction, generally accepted accounting principles require management to determine that the forecasted transaction is probable of occurring. Those principles require that the likelihood that the transaction will take place not be based solely on management's intent. Instead, the transaction's probability should be supported by observable facts and the attendant circumstances, such as the following:

- The frequency of similar past transactions
- The financial and operational ability of the entity to carry out the transaction
- The extent of loss that could result if the transaction does not occur
- The likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose

The auditor should evaluate management's determination of whether a forecasted transaction is probable.

Assertions About Securities Based on Management's Intent and Ability

.56 Generally accepted accounting principles require that management's intent and ability be considered in valuing certain securities; for example, whether—

- Debt securities are classified as held-to-maturity and reported at their cost depends on management's intent and ability to hold them to their maturity.
- Equity securities are reported using the equity method depends on management's ability to significantly influence the investee.
- Equity securities are classified as trading or available-for-sale depends on management's intent and objectives in investing in the securities.

.57 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

In evaluating management's intent and ability, the auditor should—

a. Obtain an understanding of the process used by management to classify securities as trading, available-for-sale, or held-to-maturity.

b. For an investment accounted for using the equity method, inquire of management as to whether the entity has the ability to exercise significant influence over the operating and financial policies of the investee and evaluate the attendant circumstances that serve as a basis for management's conclusions.

c. If the entity accounts for the investment contrary to the presumption established by generally accepted accounting principles for use of the equity method, obtain sufficient appropriate evidential matter about whether that presumption has been overcome and whether appropriate disclosure is made regarding the reasons for not accounting for the investment in keeping with that presumption.

d. Consider whether management's activities corroborate or conflict with its stated intent. For example, the auditor should evaluate an assertion that management intends to hold debt securities to their maturity by examining evidence such as documentation of management's strategies and sales and other historical activities with respect to those securities and similar securities.

e. Determine whether generally accepted accounting principles require management to document its intentions and specify the content and timeliness of that documentation.[19] The auditor should inspect the documentation and obtain evidential matter about its timeliness. Unlike the formal documentation required for hedging activities, evidential matter supporting the classification of debt and equity securities may be more informal.

f. Determine whether management's activities, contractual agreements, or the entity's financial condition provide evidence of its ability. Examples follow.

(1) The entity's financial position, working capital needs, operating results, debt agreements, guarantees, alternate sources of liquidity, and other relevant contractual obligations, as well as laws and regulations, may provide evidence about an entity's ability to hold debt securities to their maturity.

(2) Management's cash flow projections may suggest that it does not have the ability to hold debt securities to their maturity.

(3) Management's inability to obtain information from an investee may suggest that it does not have the ability to significantly influence the investee.

(4) If the entity asserts that it maintains effective control over securities transferred under a repurchase agreement, the contractual agreement may be such that the entity actually surrendered control over the securities and therefore should account for the transfer as a sale instead of a secured borrowing.

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[19] FASB Statement No. 115 requires an investor to document the classification of debt and equity securities into one of three categories—held-to-maturity, available-for-sale, or trading—at their acquisition.

Management Representations

.58 Section 333, *Management Representations*, provides guidance to auditors in obtaining written representations from management. The auditor ordinarily should obtain written representations from management confirming aspects of management's intent and ability that affect assertions about derivatives and securities, such as its intent and ability to hold a debt security until its maturity or to enter into a forecasted transaction for which hedge accounting is applied. In addition, the auditor should consider obtaining written representations from management confirming other aspects of derivatives and securities transactions that affect assertions about them.[20]

Effective Date

.59 This section is effective for audits of financial statements for fiscal years ending on or after June 30, 2001. Early application is permitted.

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[20] Appendix B of section 333.17 provides illustrative representations about derivatives and securities transactions.

AU Section 333

Management Representations

(Supersedes SAS No. 19)

Source: SAS No. 85; SAS No. 89; SAS No. 99; Auditing Standard No. 5; Auditing Standard Nos. 8–15; Auditing Standard No. 16.

See section 9333 for interpretations of this section.

Effective for audits of financial statements for periods ending on or after June 30, 1998, unless otherwise indicated.

Introduction

.01 This section establishes a requirement that the independent auditor obtain written representations from management as a part of an audit of financial statements performed in accordance with generally accepted auditing standards and provides guidance concerning the representations to be obtained.

Reliance on Management Representations

.02 During an audit, management makes many representations to the auditor, both oral and written, in response to specific inquiries or through the financial statements. Such representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit. Written representations from management ordinarily confirm representations explicitly or implicitly given to the auditor, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding concerning the matters that are the subject of the representations.[1]

.03 The auditor obtains written representations from management to complement other auditing procedures. In many cases, the auditor applies auditing procedures specifically designed to obtain evidential matter concerning matters that also are the subject of written representations. For example, after the auditor performs the procedures prescribed in section 334, *Related Parties*, even if the results of those procedures indicate that transactions with related parties have been properly disclosed, the auditor should obtain a written representation to document that management has no knowledge of any such transactions that have not been properly disclosed. In some circumstances, evidential matter that can be obtained by the application of auditing procedures other than inquiry is limited; therefore, the auditor obtains written representations to provide additional evidential matter. For example, if an entity plans to discontinue a line of business and the auditor is not able to obtain sufficient information through other auditing procedures to corroborate the plan or intent, the auditor obtains a written representation to provide evidence of management's intent.

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[1] Section 230, *Due Professional Care in the Performance of Work*, states, "The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest."

.04 If a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified.

Obtaining Written Representations

.05 *[The following paragraph is effective for audits of fiscal years ending on or after December 15, 2012. See PCAOB Release 2012-004.]*

Written representations from management should be obtained for all financial statements and periods covered by the auditor's report.[2] For example, if comparative financial statements are reported on, the written representations obtained at the completion of the most recent audit should address all periods being reported on. The specific written representations obtained by the auditor will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. The auditor should provide a copy of the representation letter to the audit committee if management has not already provided the representation letter to the audit committee.

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 75–77 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, for additional required written representations to be obtained from management.

.06 In connection with an audit of financial statements presented in accordance with generally accepted accounting principles, specific representations should relate to the following matters:[3]

Financial Statements

a. Management's acknowledgment of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

b. Management's belief that the financial statements are fairly presented in conformity with generally accepted accounting principles.

Completeness of Information

c. Availability of all financial records and related data.

d. Completeness and availability of all minutes of meetings of stockholders, directors, and committees of directors.

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[2] An illustrative representation letter from management is contained in appendix A, "Illustrative Management Representation Letter" [paragraph .16].

[3] Specific representations also are applicable to financial statements presented in conformity with a comprehensive basis of accounting other than generally accepted accounting principles. The specific representations to be obtained should be based on the nature and basis of presentation of the financial statements being audited.

e. Communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.

f. Absence of unrecorded transactions.

Recognition, Measurement, and Disclosure

g. Management's belief that the effects of any uncorrected financial statement misstatements[4] aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.[5] (A summary of such items should be included in or attached to the letter.)[6, 7]

h. Management's acknowledgment of its responsibility for the design and implementation of programs and controls to prevent and detect fraud.

i. Knowledge of fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements.[8]

j. Knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.

k. Plans or intentions that may affect the carrying value or classification of assets or liabilities.

l. Information concerning related-party transactions and amounts receivable from or payable to related parties.[9]

m. Guarantees, whether written or oral, under which the entity is contingently liable.

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[4] 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. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[5] If management believes that certain of the identified items are not misstatements, management's belief may be acknowledged by adding to the representation, for example, "We do not agree that items XX and XX constitute misstatements because [description of reasons]." [Footnote added, effective for audits of financial statements for periods beginning on or after December 15, 1999, by Statement on Auditing Standards No. 89.]

[6] Paragraph 11 of Auditing Standard No. 14, *Evaluating Audit Results*, states that the auditor may designate an amount below which misstatements need not be accumulated. Similarly, the summary of uncorrected misstatements included in or attached to the representation letter need not include such misstatements. The summary should include sufficient information to provide management with an understanding of the nature, amount, and effect of the uncorrected misstatements. Similar items may be aggregated. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[7] The communication to management of immaterial misstatements aggregated by the auditor does not constitute a communication pursuant to section 317, *Illegal Acts by Clients*, paragraph .17, Section 10A of the Securities Exchange Act of 1934, or section 316, *Consideration of Fraud in a Financial Statement Audit*, paragraphs .79 through .82. The auditor may have additional communication responsibilities pursuant to section 317, Section 10A of the Securities Exchange Act of 1934, or section 316. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[8] [Footnote deleted by the issuance of Statement on Auditing Standards No. 99, October 2002.]

[9] See section 334. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

n. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

o. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.[10]

p. Unasserted claims or assessments that the entity's lawyer has advised are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies* [AC section C59].[11]

q. Other liabilities and gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5 [AC section C59].[12]

r. Satisfactory title to assets, liens or encumbrances on assets, and assets pledged as collateral.

s. Compliance with aspects of contractual agreements that may affect the financial statements.

Subsequent Events

t. Information concerning subsequent events.[13]

[As amended, effective for audits of financial statements for periods beginning on or after December 15, 1999, by Statement on Auditing Standards No. 89. As amended, effective for audits of financial statements for periods beginning on or after December 15, 2002, by Statement on Auditing Standards No. 99.]

.07 The representation letter ordinarily should be tailored to include additional appropriate representations from management relating to matters specific to the entity's business or industry.[14] Examples of additional representations that may be appropriate are provided in appendix B, "Additional Illustrative Representations" [paragraph .17].

.08 Management's representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the auditor have reached an understanding on materiality for this purpose. Materiality may be different for different representations. A discussion of materiality may be included explicitly in the

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[10] See section 317. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

[11] See section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, paragraph .05*d*. If the entity has not consulted a lawyer regarding litigation, claims, and assessments, the auditor normally would rely on the review of internally available information and obtain a written representation by management regarding the lack of litigation, claims, and assessments; see auditing Interpretation No. 6, "Client Has Not Consulted a Lawyer" (section 9337.15–.17). [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

[12] See section 337.05*b*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

[13] See section 560, *Subsequent Events*, paragraph .12, section 711, *Filings Under Federal Securities Statutes*, paragraph .10, and section 634, *Letters for Underwriters and Certain Other Requesting Parties*, paragraph .45, footnote 29. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

[14] Certain AICPA Audit Guides recommend that the auditor obtain written representations concerning matters that are unique to a particular industry. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

representation letter, in either qualitative or quantitative terms. Materiality considerations would not apply to those representations that are not directly related to amounts included in the financial statements, for example, items (*a*), (*c*), (*d*), and (*e*) above. In addition, because of the possible effects of fraud on other aspects of the audit, materiality would not apply to item (*h*) above with respect to management or those employees who have significant roles in internal control.

.09 *[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]*

The written representations should be addressed to the auditor. Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to or disclosure in the financial statements, the representations should be made as of the date of the auditor's report. [If the auditor "dual dates" his or her report, the auditor should consider whether obtaining additional representations relating to the subsequent event is appropriate. See section 530, *Dating of the Independent Auditor's Report*, paragraph .05]. The letter should be signed by those members of management with overall responsibility for financial and operating matters whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Such members of management normally include the chief executive officer and chief financial officer or others with equivalent positions in the entity.

.10 If current management was not present during all periods covered by the auditor's report, the auditor should nevertheless obtain written representations from current management on all such periods. The specific written representations obtained by the auditor will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. As discussed in paragraph .08, management's representations may be limited to matters that are considered either individually or collectively material to the financial statements.

.11 In certain circumstances, the auditor may want to obtain written representations from other individuals. For example, he or she may want to obtain written representations about the completeness of the minutes of the meetings of stockholders, directors, and committees of directors from the person responsible for keeping such minutes. Also, if the independent auditor performs an audit of the financial statements of a subsidiary but does not audit those of the parent company, he or she may want to obtain representations from management of the parent company concerning matters that may affect the subsidiary, such as related-party transactions or the parent company's intention to provide continuing financial support to the subsidiary.

.12 There are circumstances in which an auditor should obtain updating representation letters from management. If a predecessor auditor is requested by a former client to reissue (or consent to the reuse of) his or her report on the financial statements of a prior period, and those financial statements are to be presented on a comparative basis with audited financial statements of a subsequent period, the predecessor auditor should obtain an updating representation letter from the management of the former client.[15] Also, when performing subsequent events procedures in connection with filings under the Securities Act of 1933, the auditor should obtain certain written representations.[16] The

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[15] See section 508, *Reports on Audited Financial Statements*, paragraph .71. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

[16] See section 711.10. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

updating management representation letter should state (*a*) whether any information has come to management's attention that would cause them to believe that any of the previous representations should be modified, and (*b*) whether any events have occurred subsequent to the balance-sheet date of the latest financial statements reported on by the auditor that would require adjustment to or disclosure in those financial statements.[17]

Scope Limitations

.13 Management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause an auditor to disclaim an opinion or withdraw from the engagement.[18] However, based on the nature of the representations not obtained or the circumstances of the refusal, the auditor may conclude that a qualified opinion is appropriate. Further, the auditor should consider the effects of the refusal on his or her ability to rely on other management representations.

.14 If the auditor is precluded from performing procedures he or she considers necessary in the circumstances with respect to a matter that is material to the financial statements, even though management has given representations concerning the matter, there is a limitation on the scope of the audit, and the auditor should qualify his or her opinion or disclaim an opinion.

Effective Date

.15 This section is effective for audits of financial statements for periods ending on or after June 30, 1998. Earlier application is permitted.

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[17] An illustrative updating management representation letter is contained in appendix C, "Illustrative Updating Management Representation Letter" [paragraph .18]. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

[18] See section 508.22–.34. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

.16

Appendix A
Illustrative Management Representation Letter

1. The following letter, which relates to an audit of financial statements prepared in conformity with generally accepted accounting principles, is presented for illustrative purposes only. The introductory paragraph should specify the financial statements and periods covered by the auditor's report, for example, "balance sheets of XYZ Company as of December 31, 19X1 and 19X0, and the related statements of income and retained earnings and cash flows for the years then ended." The written representations to be obtained should be based on the circumstances of the engagement and the nature and basis of presentation of the financial statements being audited. (See appendix B [paragraph .17]).

2. If matters exist that should be disclosed to the auditor, they should be indicated by modifying the related representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, the final paragraph could be modified as follows: "To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred. . . ." In appropriate circumstances, item 9 could be modified as follows: "The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except for its plans to dispose of segment A, as disclosed in Note X to the financial statements, which are discussed in the minutes of the December 7, 20X1, meeting of the board of directors." Similarly, if management has received a communication regarding an allegation of fraud or suspected fraud, item 8 could be modified as follows: "Except for the allegation discussed in the minutes of the December 7, 20X1, meeting of the board of directors (or disclosed to you at our meeting on October 15, 20X1), we have no knowledge of any allegations of fraud or suspected fraud affecting the company received in communications from employees, former employees, analysts, regulators, short sellers, or others."

3. The qualitative discussion of materiality used in the illustrative letter is adapted from FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*.

4. Certain terms are used in the illustrative letter that are described elsewhere in authoritative literature. Examples are fraud, in section 316, and related parties, in section 334, footnote 1. To avoid misunderstanding concerning the meaning of such terms, the auditor may wish to furnish those definitions to management or request that the definitions be included in the written representations.

5. The illustrative letter assumes that management and the auditor have reached an understanding on the limits of materiality for purposes of the written representations. However, it should be noted that a materiality limit would not apply for certain representations, as explained in paragraph .08 of this section.

6.

[*Date*]

To [*Independent Auditor*]

We are providing this letter in connection with your audit(s) of the [*identification of financial statements*] of [*name of entity*] as of [*dates*] and for the [*periods*]

for the purpose of expressing an opinion as to whether the [*consolidated*] financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of [*name of entity*] in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the [*consolidated*] financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, [*as of (date of auditor's report),*] the following representations made to you during your audit(s).

1. The financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America.
2. We have made available to you all—
    a. Financial records and related data.
    b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
5. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.[1]
6. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
7. We have no knowledge of any fraud or suspected fraud affecting the entity involving—
    a. Management,
    b. Employees who have significant roles in internal control, or
    c. Others where the fraud could have a material effect on the financial statements.

[1] If management believes that certain of the identified items are not misstatements, management's belief may be acknowledged by adding to the representation, for example, "We do not agree that items XX and XX constitute misstatements because [*description of reasons*]." [Footnote added effective for audits of financial statements for periods beginning on or after December 15, 1999, by Statement on Auditing Standards No. 89.]

8. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.
9. The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
10. The following have been properly recorded or disclosed in the financial statements:
    a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
    b. Guarantees, whether written or oral, under which the company is contingently liable.
    c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties. [Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year*.]
11. There are no—
    a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
    b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.[2]
    c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
12. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.
13. The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

[*Add additional representations that are unique to the entity's business or industry. See paragraph .07 and appendix B [paragraph .17] of this section.*]

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[2] In the circumstance discussed in footnote 11 of this section, this representation might be worded as follows:

> We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

[Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

_____
[*Name of Chief Executive Officer and Title*]

_____
[*Name of Chief Financial Officer and Title*]

[As amended, effective for audits of financial statements for periods beginning on or after December 15, 1999 by Statement on Auditing Standards No. 89. As amended, effective for audits of financial statements for periods beginning on or after December 15, 2002, by Statement on Auditing Standards No. 99.]

.17

Appendix B
Additional Illustrative Representations

1. As discussed in paragraph .07 of this section, representation letters ordinarily should be tailored to include additional appropriate representations from management relating to matters specific to the entity's business or industry. The auditor also should be aware that certain AICPA Audit Guides recommend that the auditor obtain written representations concerning matters that are unique to a particular industry. The following is a list of additional representations that may be appropriate in certain situations. This list is not intended to be all-inclusive. The auditor also should consider the effects of pronouncements issued subsequent to the issuance of this section.

General	
Condition	***Illustrative Example***
Unaudited interim information accompanies the financial statements.	The unaudited interim financial information accompanying [*presented in Note X to*] the financial statements for the [*identify all related periods*] has been prepared and presented in conformity with generally accepted accounting principles applicable to interim financial information [*and with Item 302(a) of Regulation S-K*]. The accounting principles used to prepare the unaudited interim financial information are consistent with those used to prepare the audited financial statements.
The impact of a new accounting principle is not known.	We have not completed the process of evaluating the impact that will result from adopting Financial Accounting Standards Board (FASB) Statement No. [*XXX, Name*], as discussed in Note [*X*]. The company is therefore unable to disclose the impact that adopting FASB Statement No. [*XXX*] will have on its financial position and the results of operations when such Statement is adopted.
There is justification for a change in accounting principles.	We believe that [*describe the newly adopted accounting principle*] is preferable to [*describe the former accounting principle]* because [*describe management's justification for the change in accounting principles*].
Financial circumstances are strained, with disclosure of management's intentions and the entity's ability to continue as a going concern.	Note [*X*] to the financial statements discloses all of the matters of which we are aware that are relevant to the company's ability to continue as a going concern, including significant conditions and events, and management's plans.

(continued)

General	
Condition	***Illustrative Example***
The possibility exists that the value of specific significant long-lived assets or certain identifiable intangibles may be impaired.	We have reviewed long-lived assets and certain identifiable intangibles to be held and used for impairment whenever events or changes in circumstances have indicated that the carrying amount of its assets might not be recoverable and have appropriately recorded the adjustment.
The entity engages in transactions with special purpose entities.	We have evaluated all transactions involving special purpose entities to determine that the accounting for such transactions is in accordance with generally accepted accounting principles. Specifically [indicate appropriate accounting principles: • Conditions pursuant to paragraph 35 of FASB Statement 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities" • EITF Issue No. 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest by the Minority Shareholder or Shareholders Have certain Approval or Veto Rights" • EITF Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions" • EITF Issue 96-21, "Implementation in Accounting for Leasing Transactions involving Special-Purpose Entities" • EITF Issue 97-1, "Implementation Issues in Accounting for Lease Transactions, including Those involving Special-Purpose Entities" • EITF Issue No. 97-2, "Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management [PPM] Entities and Certain Other Entities with Contractual Management Arrangements" • EITF Issue No. 00-4, "Majority Owner's Accounting for a transaction in the Shares of a Consolidated Subsidiary and a Derivative Indexed to the Minority Interest in That Subsidiary."]

General	
Condition	***Illustrative Example***
The work of a specialist has been used by the entity.	We agree with the findings of specialists in evaluating the [*describe assertion*] and have adequately considered the qualifications of the specialist in determining the amounts and disclosures used in the financial statements and underlying accounting records. We did not give or cause any instructions to be given to specialists with respect to the values or amounts derived in an attempt to bias their work, and we are not otherwise aware of any matters that have had an impact on the independence or objectivity of the specialists.

Assets	
Condition	***Illustrative Examples***
Cash Disclosure is required of compensating balances or other arrangements involving restrictions on cash balances, line of credit, or similar arrangements.	Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances, line of credit, or similar arrangements have been properly disclosed.
Financial Instruments Management intends to and has the ability to hold to maturity debt securities classified as held-to-maturity.	Debt securities that have been classified as held-to-maturity have been so classified due to the company's intent to hold such securities, to maturity and the company's ability to do so. All other debt securities have been classified as available-for-sale or trading.
Management considers the decline in value of debt or equity securities to be temporary.	We consider the decline in value of debt or equity securities classified as either available-for-sale or held-to-maturity to be temporary.
Management has determined the fair value of significant financial instruments that do not have readily determinable market values.	The methods and significant assumptions used to determine fair values of financial instruments are as follows: [*describe methods and significant assumptions used to determine fair values of financial instruments].* The methods and significant assumptions used result in a measure of fair value appropriate for financial statement measurement and disclosure purposes.

(continued)

Assets	
Condition	***Illustrative Examples***
There are financial instruments with off-balance-sheet risk and financial instruments with concentrations of credit risk.	The following information about financial instruments with off-balance-sheet risk and financial instruments with concentrations of credit risk has been properly disclosed in the financial statements: 1. The extent, nature, and terms of financial instruments with off-balance-sheet risk 2. The amount of credit risk of financial instruments with off-balance-sheet risk and information about the collateral supporting such financial instruments 3. Significant concentrations of credit risk arising from all financial instruments and information about the collateral supporting such financial instruments
Receivables Receivables have been recorded in the financial statements.	Receivables recorded in the financial statements represent valid claims against debtors for sales or other charges arising on or before the balance-sheet date and have been appropriately reduced to their estimated net realizable value.
Inventories Excess or obsolete inventories exist.	Provision has been made to reduce excess or obsolete inventories to their estimated net realizable value.
Investments There are unusual considerations involved in determining the application of equity accounting.	*[For investments in common stock that are either nonmarketable or of which the entity has a 20 percent or greater ownership interest, select the appropriate representation from the following:]* • The equity method is used to account for the company's investment in the common stock of [*investee*] because the company has the ability to exercise significant influence over the investee's operating and financial policies. • The cost method is used to account for the company's investment in the common stock of [investee] because the company does not have the ability to exercise significant influence over the investee's operating and financial policies.

Assets	
Condition	***Illustrative Examples***
Deferred Charges Material expenditures have been deferred.	We believe that all material expenditures that have been deferred to future periods will be recoverable.
Deferred Tax Assets A deferred tax asset exists at the balance-sheet date.	The valuation allowance has been determined pursuant to the provisions of FASB Statement No. 109, *Accounting for Income Taxes*, including the company's estimation of future taxable income, if necessary, and is adequate to reduce the total deferred tax asset to an amount that will more likely than not be realized. [*Complete with appropriate wording detailing how the entity determined the valuation allowance against the deferred tax asset.*] or A valuation allowance against deferred tax assets at the balance-sheet date is not considered necessary because it is more likely than not the deferred tax asset will be fully realized.

Liabilities	
Condition	***Illustrative Examples***
Debt Short-term debt could be refinanced on a long-term basis and management intends to do so.	The company has excluded short-term obligations totaling $[*amount*] from current liabilities because it intends to refinance the obligations on a long-term basis. *[Complete with appropriate wording detailing how amounts will be refinanced as follows:*] • The company has issued a long-term obligation [*debt security*] after the date of the balance sheet but prior to the issuance of the financial statements for the purpose of refinancing the short-term obligations on a long-term basis. • The company has the ability to consummate the refinancing, by using the financing agreement referred to in Note [*X*] to the financial statements.
Tax-exempt bonds have been issued.	Tax-exempt bonds issued have retained their tax-exempt status.

(continued)

Liabilities	
Condition	***Illustrative Examples***
Taxes Management intends to reinvest undistributed earnings of a foreign subsidiary.	We intend to reinvest the undistributed earnings of [*name of foreign subsidiary*].
Contingencies Estimates and disclosures have been made of environmental remediation liabilities and related loss contingencies.	Provision has been made for any material loss that is probable from environmental remediation liabilities associated with [*name of site*]. We believe that such estimate is reasonable based on available information and that the liabilities and related loss contingencies and the expected outcome of uncertainties have been adequately described in the company's financial statements.
Agreements may exist to repurchase assets previously sold.	Agreements to repurchase assets previously sold have been properly disclosed.
Pension and Postretirement Benefits An actuary has been used to measure pension liabilities and costs.	We believe that the actuarial assumptions and methods used to measure pension liabilities and costs for financial accounting purposes are appropriate in the circumstances.
There is involvement with a multiemployer plan.	We are unable to determine the possibility of a withdrawal liability in a multiemployer benefit plan. or We have determined that there is the possibility of a withdrawal liability in a multiemployer plan in the amount of $[*XX*].
Postretirement benefits have been eliminated.	We do not intend to compensate for the elimination of postretirement benefits by granting an increase in pension benefits. or We plan to compensate for the elimination of postretirement benefits by granting an increase in pension benefits in the amount of $[*XX*].
Employee layoffs that would otherwise lead to a curtailment of a benefit plan are intended to be temporary.	Current employee layoffs are intended to be temporary.

Liabilities	
Condition	***Illustrative Examples***
Management intends to either continue to make or not make frequent amendments to its pension or other postretirement benefit plans, which may affect the amortization period of prior service cost, or has expressed a substantive commitment to increase benefit obligations.	We plan to continue to make frequent amendments to its pension or other postretirement benefit plans, which may affect the amortization period of prior service cost. or We do not plan to make frequent amendments to its pension or other postretirement benefit plans.

Equity	
Condition	***Illustrative Example***
There are capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.	Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements have been properly disclosed.

Income Statement	
Condition	***Illustrative Example***
There may be a loss from sales commitments.	Provisions have been made for losses to be sustained in the fulfillment of or from inability to fulfill any sales commitments.
There may be losses from purchase commitments.	Provisions have been made for losses to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of prevailing market prices.
Nature of the product or industry indicates the possibility of undisclosed sales terms.	We have fully disclosed to you all sales terms, including all rights of return or price adjustments and all warranty provisions.

[Revised, April 2002, to reflect conforming changes necessary due to the issuance of recent guidance on special purpose entity transactions.]

.18

Appendix C

Illustrative Updating Management Representation Letter

1. The following letter is presented for illustrative purposes only. It may be used in the circumstances described in paragraph .12 of this section. Management need not repeat all of the representations made in the previous representation letter.

2. If matters exist that should be disclosed to the auditor, they should be indicated by listing them following the representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, the final paragraph could be modified as follows: "To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred. . . ."

3.

[*Date*]

To [*Auditor*]

In connection with your audit(s) of the [*identification of financial statements*] of [*name of entity*] as of [*dates*] and for the [*periods*] for the purpose of expressing an opinion as to whether the [*consolidated*] financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of [*name of entity*] in conformity with accounting principles generally accepted in the United States of America, you were previously provided with a representation letter under date of [*date of previous representation letter*]. No information has come to our attention that would cause us to believe that any of those previous representations should be modified.

To the best of our knowledge and belief, no events have occurred subsequent to [*date of latest balance sheet reported on by the auditor*] and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

_____

[*Name of Chief Executive Officer and Title*]

_____

[*Name of Chief Financial Officer and Title*]

[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

AU Section 9333

Management Representations: Auditing Interpretations of Section 333

1. Management Representations on Violations and Possible Violations of Laws and Regulations

.01 *Question*—Section 333, *Management Representations*, lists matters for which the auditor ordinarily obtains written representations from management. One of those matters is: Violations or possible violations of laws or regulations whose effects should be considered for disclosure in financial statements or as a basis for recording a loss contingency.

.02 Guidance on evaluating the need to disclose litigation, claims, and assessments that may result from possible violations is provided by FASB Statement No. 5, *Accounting for Contingencies* [AC section C59]. Section 317, *Illegal Acts by Clients*, provides guidance on evaluating the materiality of illegal acts. Does the representation regarding "possible violations" include matters beyond those described in FASB Statement No. 5 [AC section C59] and section 317?

.03 *Interpretation*—No. Section 333 did not change the relevant criteria for evaluating the need for disclosure of violations and possible violations of laws or regulations. In requesting the representation on possible violations, the auditor is not asking for management's speculation on all possibilities of legal challenges to its actions.

.04 The representation concerns matters that have come to management's attention and that are significant enough that they should be considered in determining whether financial statement disclosures are necessary. It recognizes that these are matters of judgment and that the need for disclosure is not always readily apparent.

[Issue Date: March, 1979.]

AU Section 334

Related Parties

(Supersedes Statement on Auditing Standards No. 6, AICPA, *Professional Standards*, vol. 1, AU sec. 335.01–.19)[*]

Source: SAS No. 45; Auditing Standard Nos. 8–15.

See section 9334 for interpretations of this section.

Effective for periods ended after September 30, 1983, unless otherwise indicated.

.01 This section provides guidance on procedures that should be considered by the auditor when he is performing an audit of financial statements in accordance with generally accepted auditing standards to identify related party relationships and transactions and to satisfy himself concerning the required financial statement accounting and disclosure.[1] The procedures set forth in this section should not be considered all-inclusive. Also, not all of them may be required in every audit.

Accounting Considerations

.02 FASB Statement No. 57, *Related Party Disclosures* [AC section R36], gives the requirements for related party disclosures. Certain accounting pronouncements prescribe the accounting treatment when related parties are involved; however, established accounting principles ordinarily do not require transactions with related parties to be accounted for on a basis different from that which would be appropriate if the parties were not related. The auditor should view related party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure. In

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[*] This section also withdraws the following auditing interpretations dated March 1976 (AICPA, Professional Standards, vol. 1, AU sec. 9335.01-.11):

- Evaluating the Adequacy of Disclosure of Related Party Transactions
- Disclosure of Commonly Controlled Parties
- Definition of "Immediate Family"

[1] Financial Accounting Standards Board Statement No. 57, *Related Party Disclosures*, paragraphs 2 through 4 [AC section R36.102-.104], contains the disclosure requirements for related party relationships and transactions. The glossary of that Statement [AC section R36.406] defines related parties as follows:

> Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

The glossary also gives definitions of the terms "affiliate," "control," "immediate family," "management," and "principal owners" [AC section R36.401-.405]. Paragraph 1 of the FASB Statement [AC section R36.101] gives examples of related party transactions.

addition, the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form.[2]

.03 Transactions that because of their nature may be indicative of the existence of related parties include[3]—

a. Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates prevailing at the time of the transaction.

b. Selling real estate at a price that differs significantly from its appraised value.

c. Exchanging property for similar property in a nonmonetary transaction.

d. Making loans with no scheduled terms for when or how the funds will be repaid.

Audit Procedures

.04 An audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related party transactions will be discovered. Nevertheless, during the course of his audit, the auditor should be aware of the possible existence of material related party transactions that could affect the financial statements and of common ownership or management control relationships for which FASB Statement No. 57 [AC section R36] requires disclosure even though there are no transactions. Many of the procedures outlined in the following paragraphs are normally performed in an audit in accordance with generally accepted auditing standards, even if the auditor has no reason to suspect that related party transactions or control relationships exist. Other audit procedures set forth in this section are specifically directed to related party transactions.

.05 In determining the scope of work to be performed with respect to possible transactions with related parties, the auditor should obtain an understanding of management responsibilities and the relationship of each component to the total entity. He should consider controls over management activities, and he should consider the business purpose served by the various components of the entity. Normally, the business structure and style of operating are based on the abilities of management, tax and legal considerations, product diversification, and geographical location. Experience has shown, however, that business structure and operating style are occasionally deliberately designed to obscure related party transactions.

.06 In the absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the ordinary course of business. The

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[2] Some pronouncements specify criteria for determining, presenting, and accounting for the substance of certain transactions and events. Examples include (1) presenting consolidated financial statements instead of separate statements of the component legal entities (Accounting Research Bulletin No. 51 [AC section C51]); (2) capitalizing leases (FASB Statement No. 13 [AC section L10]); and (3) imputing an appropriate interest rate when the face amount of a note does not reasonably represent the present value of the consideration given or received in exchange for it (Accounting Principles Board Opinion No. 21 [AC section I69]; FASB Statement No. 94 [AC section C51]). [Footnote revised, June 1993, to reflect conforming changes necessary due to the issuance of Statement of Position 93-3.]

[3] FASB Statement No. 57, paragraph 1 [AC section R36.101], gives other examples of common types of transactions with related parties, and it states that "transactions between related parties are considered to be related party transactions even though they may not be given accounting recognition."

auditor should, however, be aware of the possibility that transactions with related parties may have been motivated solely, or in large measure, by conditions similar to the following:

a. Lack of sufficient working capital or credit to continue the business

b. An urgent desire for a continued favorable earnings record in the hope of supporting the price of the company's stock

c. An overly optimistic earnings forecast

d. Dependence on a single or relatively few products, customers, or transactions for the continuing success of the venture

e. A declining industry characterized by a large number of business failures

f. Excess capacity

g. Significant litigation, especially litigation between stockholders and management

h. Significant obsolescence dangers because the company is in a high-technology industry

Determining the Existence of Related Parties

.07 The auditor should place emphasis on testing material transactions with parties he knows are related to the reporting entity. Certain relationships, such as parent-subsidiary or investor-investee, may be clearly evident. Determining the existence of others requires the application of specific audit procedures, which may include the following:

a. Evaluate the company's procedures for identifying and properly accounting for related party transactions.

b. Request from appropriate management personnel the names of all related parties and inquire whether there were any transactions with these parties during the period.

c. Review filings by the reporting entity with the Securities and Exchange Commission and other regulatory agencies for the names of related parties and for other businesses in which officers and directors occupy directorship or management positions.

d. Determine the names of all pension and other trusts established for the benefit of employees and the names of their officers and trustees.[4]

e. Review stockholder listings of closely held companies to identify principal stockholders.

f. Review prior years' working papers for the names of known related parties.

g. Inquire of predecessor, principal, or other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions.

h. Review material investment transactions during the period under audit to determine whether the nature and extent of investments during the period create related parties.

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[4] According to FASB Statement No. 57, paragraph 24(f) [AC section R36.406] "trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management," are related parties.

Identifying Transactions With Related Parties

.08 The following procedures are intended to provide guidance for identifying material transactions with parties known to be related and for identifying material transactions that may be indicative of the existence of previously undetermined relationships:

a. Provide audit personnel performing segments of the audit or auditing and reporting separately on the accounts of related components of the reporting entity with the names of known related parties so that they may become aware of transactions with such parties during their audits.

b. Review the minutes of meetings of the board of directors and executive or operating committees for information about material transactions authorized or discussed at their meetings.

c. Review proxy and other material filed with the Securities and Exchange Commission and comparable data filed with other regulatory agencies for information about material transactions with related parties.

d. Review conflict-of-interests statements obtained by the company from its management.[5]

e. Review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders for indications of previously undisclosed relationships.

f. Consider whether transactions are occurring, but are not being given accounting recognition, such as receiving or providing accounting, management or other services at no charge or a major stockholder absorbing corporate expenses.

g. Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.

h. Review confirmations of compensating balance arrangements for indications that balances are or were maintained for or by related parties.

i. Review invoices from law firms that have performed regular or special services for the company for indications of the existence of related parties or related party transactions.

j. Review confirmations of loans receivable and payable for indications of guarantees. When guarantees are indicated, determine their nature and the relationships, if any, of the guarantors to the reporting entity.

Examining Identified Related Party Transactions

.09 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

After identifying related party transactions, the auditor should apply the procedures he considers necessary to obtain satisfaction concerning the purpose,

[5] Conflict-of-interests statements are intended to provide the board of directors with information about the existence or nonexistence of relationships between the reporting persons and parties with whom the company transacts business.

nature, and extent of these transactions and their effect on the financial statements. The procedures should be directed toward obtaining and evaluating sufficient appropriate evidential matter and should extend beyond inquiry of management. Procedures that should be considered include the following:

a. Obtain an understanding of the business purpose of the transaction.[6]

b. Examine invoices, executed copies of agreements, contracts, and other pertinent documents, such as receiving reports and shipping documents.

c. Determine whether the transaction has been approved by the board of directors or other appropriate officials.

d. Test for reasonableness the compilation of amounts to be disclosed, or considered for disclosure, in the financial statements.

e. Arrange for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related party transactions by the auditors for each of the parties, with appropriate exchange of relevant information.

f. Inspect or confirm and obtain satisfaction concerning the transferability and value of collateral.

.10 When necessary to fully understand a particular transaction, the following procedures, which might not otherwise be deemed necessary to comply with generally accepted auditing standards, should be considered.[7]

a. Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction.

b. Inspect evidence in possession of the other party or parties to the transaction.

c. Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction.

d. Refer to financial publications, trade journals, credit agencies, and other information sources when there is reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business have been transacted may lack substance.

e. With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction. Such information may be obtained from audited financial statements, unaudited financial statements, income tax returns, and reports issued by regulatory agencies, taxing authorities, financial publications, or credit agencies. The auditor should decide on the degree of assurance required and the extent to which available information provides such assurance.

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[6] Until the auditor understands the business sense of material transactions, he cannot complete his audit. If he lacks sufficient specialized knowledge to understand a particular transaction, he should consult with persons who do have the requisite knowledge.

[7] Arrangements for certain procedures should be made or approved in advance by appropriate client officials.

Disclosure

.11 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

For each material related party transaction (or aggregation of similar transactions) or common ownership or management control relationship for which FASB Statement No. 57 [AC section R36] requires disclosure, the auditor should consider whether he has obtained sufficient appropriate evidential matter to understand the relationship of the parties and, for related party transactions, the effects of the transaction on the financial statements. He should then evaluate all the information available to him concerning the related party transaction or control relationship and satisfy himself on the basis of his professional judgment that it is adequately disclosed in the financial statements.[8]

.12 Except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been. Accordingly, it is difficult to substantiate representations that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions.[9] If such a representation is included in the financial statements and the auditor believes that the representation is unsubstantiated by management, he should express a qualified or adverse opinion because of a departure from generally accepted accounting principles, depending on materiality (see section 508.35 and .36).

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[8] The disclosure standards are contained in FASB Statement No. 57, paragraphs 2 through 4 [AC section R36.102–.104]. Also, see paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[9] FASB Statement No. 57, paragraph 3 [AC section R36.103], states that if representations are made about transactions with related parties, the representations "shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated."

AU Section 9334*

Related Parties: Auditing Interpretations of Section 334

Source: Auditing Standard Nos. 8–15.

[1.] Evaluating the Adequacy of Disclosure of Related Party Transactions

[.01–.05] [Withdrawn August, 1983, by SAS No. 45.] (See section 334.)

[2.] Disclosure of Commonly Controlled Parties

[.06–.09] [Withdrawn August, 1983, by SAS No. 45.] (See section 334.)

[3.] Definition of "Immediate Family"

[.10–.11] [Withdrawn August, 1983, by SAS No. 45.] (See section 334.)

4. Exchange of Information Between the Principal and Other Auditor on Related Parties

.12 *Question*—Section 334, *Related Parties*, paragraphs .04 and .07, states that "during the course of his audit, the auditor should be aware of the possible existence of material related party transactions," and that determining the existence of related party transactions may require the inquiry of the "principal, or other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions." When should that inquiry be made?

.13 *Interpretation*—The principal auditor and the other auditor should each obtain from the other the names of known related parties and the other information referred to above. Ordinarily, that exchange of information should be made at an early stage of the audit.

[Issue Date: April, 1979.]

5. Examination of Identified Related Party Transactions with a Component

.14 *Question*—According to section 334.09, once related party transactions have been identified, "the auditor should apply the procedures he considers necessary to obtain satisfaction concerning the purpose, nature and extent of these transactions and their effect on the financial statements." When there is a principal auditor-other auditor relationship, how may the auditors obtain that satisfaction regarding transactions that may involve not only the components[1] they are auditing, but also, other components?

.15 *Interpretation*—Audit procedures may sometimes have to be applied to records of components being audited by the other. One auditor may arrange

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* [Section number changed August, 1983, to correspond to section 334, *Related Parties*.]

[1] For the purpose of this interpretation, the entities whose separate financial statements collectively comprise the consolidated or other financial statements are referred to as components.

to perform those procedures himself, or he may request the other to do so.[2] There may be circumstances when there are unusual or complex related party transactions and an auditor believes that access to relevant portions of the other's work papers is essential to his understanding of the effects of those transactions on the financial statements he is auditing. In those circumstances, access ordinarily should be provided.[3]

[Issue Date: April, 1979.]

6. The Nature and Extent of Auditing Procedures for Examining Related Party Transactions

.16 *Question*—Section 334, *Related Parties*, provides general guidance about the types of procedures an auditor might apply to identified related party transactions. How extensive should the auditor's procedures be to examine related party transactions?

.17 *Interpretation*—The auditor's procedures should be sufficient to provide reasonable assurance that related party transactions are adequately disclosed and that identified related party transactions do not contain misstatements that, when aggregated with misstatements in other balances or classes of transactions, could be material to the financial statements taken as a whole. As in examining any other material account balance or class of transactions, the auditor needs to consider audit risk[4] and design and apply appropriate substantive tests to evaluate management's assertions.

.18 The risk associated with management's assertions about related party transactions is often assessed as higher than for many other types of transactions because of the possibility that the parties to the transaction are motivated by reasons other than those that exist for most business transactions.[5]

.19 The higher the auditor's assessment of risk regarding related party transactions, the more extensive or effective the audit tests should be. For example, the auditor's tests regarding valuation of a receivable from an entity under common control might be more extensive than for a trade receivable of the same size because the common parent may be motivated to obscure the substance of the transaction. In assessing the risk of the related party transactions the auditor obtains an understanding of the business purpose of the transactions. Until the auditor understands the business sense of material transactions, he cannot complete his audit. If he lacks sufficient specialized knowledge to obtain that understanding for a particular transaction, he should consult with persons who do have the requisite knowledge. In addition, to understand the transaction, or obtain evidence regarding it, the auditor may have to refer to audited or unaudited financial statements of the related party, apply procedures at the related party, or in some cases audit the financial statements of the related party.

.20 *Question*—Section 334, *Related Parties*, paragraph .07, states that specific audit procedures should be applied to determine if related parties exist.

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[2] In this case, the auditor should follow the guidance in the interpretation titled *Specific Procedures Performed by Other Auditors at the Principal Auditor's Request*, section 9543.01-.03.

[3] There is no intention in this interpretation to modify section 543.12*c* regarding the principal auditor's consideration of review of the other auditor's workpapers when he decides not to make reference to the other auditor.

[4] Audit risk and its components are described in Auditing Standard No. 8, *Audit Risk*. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[5] See section 334.06.

That paragraph also suggests some specific audit procedures to identify related parties that the auditor should consider. What other audit procedures for determining the existence of related parties should the auditor consider?

.21 *Interpretation*—The auditor should consider obtaining representations from the entity's senior management and its board of directors about whether they or any other related parties engaged in any transactions with the entity during the period.

[Issue Date: May, 1986.]

7. Management's and Auditor's Responsibilities With Regard to Related Party Disclosures Prefaced by Terminology Such As "Management Believes That"

.22 *Question*—Management discloses in its financial statements that a related party transaction was consummated on terms equivalent to those that prevail in arm's length transactions, and prefaces the representation with a phrase such as "Management believes that" or "It is the Company's belief that." Does the use of such terminology change management's responsibility to substantiate the representation?

.23 *Interpretation*—No. FASB Statement No. 57, *Related Party Disclosures*, paragraph 3 [AC section R36.103], states that the representations about a related party transaction "shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated." A preface to a disclosure such as "Management believes that" or "It is the Company's belief that" does not change management's responsibility to substantiate the representation. Section 334, *Related Parties*, paragraph .12 (section 334.12), indicates that if such a representation is included in the financial statements and the auditor believes that the representation is unsubstantiated by management, he should express a qualified or adverse opinion because of a departure from generally accepted accounting principles, depending on materiality.

[Issue Date: May, 2000.]

AU Section 336

Using the Work of a Specialist

(Supersedes SAS No. 11)

Source: SAS No. 73; Auditing Standard Nos. 8–15.

See section 9336 for interpretations of this section.

Effective for audits of periods ending on or after December 15, 1994.

Introduction and Applicability

.01 The purpose of this section is to provide guidance to the auditor who uses the work of a specialist in performing an audit in accordance with generally accepted auditing standards. For purposes of this section, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing.[1]

.02 Specialists to which this section applies include, but are not limited to, actuaries, appraisers, engineers, environmental consultants, and geologists. This section also applies to attorneys engaged as specialists in situations other than to provide services to a client concerning litigation, claims, or assessments to which section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, applies. For example, attorneys may be engaged by a client or by the auditor as specialists in a variety of other circumstances, including interpreting the provisions of a contractual agreement.

.03 The guidance in this section is applicable when—

a. Management engages or employs a specialist and the auditor uses that specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions.

b. Management engages a specialist employed by the auditor's firm to provide advisory services[2] and the auditor uses that specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions.

c. The auditor engages a specialist and uses that specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions.

.04 The guidance provided in this section applies to audits of financial statements prepared in conformity with generally accepted accounting principles (GAAP)[3] and to engagements performed under section 623, *Special Reports*, including a comprehensive basis of accounting other than GAAP.

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[1] 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. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[2] The auditor should consider the effect, if any, that using the work of a specialist employed by the auditor's firm has on independence.

[3] References in this section to "financial statements" and to "generally accepted accounting principles" include special reports covered under section 623, *Special Reports*.

.05 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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.

Decision to Use the Work of a Specialist

.06 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor's education and experience enable him or her to be knowledgeable about business matters in general, but the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. During the audit, however, an auditor may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain appropriate evidential matter.

.07 Examples of the types of matters that the auditor may decide require him or her to consider using the work of a specialist include, but are not limited to, the following:

a. Valuation (for example, special-purpose inventories, high-technology materials or equipment, pharmaceutical products, complex financial instruments, real estate, restricted securities, works of art, and environmental contingencies)

b. Determination of physical characteristics relating to quantity on hand or condition (for example, quantity or condition of minerals, mineral reserves, or materials stored in stockpiles)

c. Determination of amounts derived by using specialized techniques or methods (for example, actuarial determinations for employee benefits obligations and disclosures, and determinations for insurance loss reserves[4])

d. Interpretation of technical requirements, regulations, or agreements (for example, the potential significance of contracts or other legal documents or legal title to property)

Qualifications and Work of a Specialist

.08 The auditor should consider the following to evaluate the professional qualifications of the specialist in determining that the specialist possesses the necessary skill or knowledge in the particular field:

a. The professional certification, license, or other recognition of the competence of the specialist in his or her field, as appropriate

b. The reputation and standing of the specialist in the views of peers and others familiar with the specialist's capability or performance

c. The specialist's experience in the type of work under consideration

[4] In the specific situation involving the audit of an insurance entity's loss reserves, an outside loss reserve specialist—that is, one who is not an employee or officer of the insurance entity—should be used. When the auditor has the requisite knowledge and experience, the auditor may serve as the loss reserve specialist. (See Statement of Position 92-4, *Auditing Insurance Entities' Loss Reserves*.)

.09 The auditor should obtain an understanding of the nature of the work performed or to be performed by the specialist. This understanding should cover the following:

a. The objectives and scope of the specialist's work

b. The specialist's relationship to the client (see paragraphs .10 and .11)

c. The methods or assumptions used

d. A comparison of the methods or assumptions used with those used in the preceding period

e. The appropriateness of using the specialist's work for the intended purpose[5]

f. The form and content of the specialist's findings that will enable the auditor to make the evaluation described in paragraph .12

Relationship of the Specialist to the Client

.10 The auditor should evaluate the relationship[6] of the specialist to the client, including circumstances that might impair the specialist's objectivity. Such circumstances include situations in which the client has the ability—through employment, ownership, contractual right, family relationship, or otherwise—to directly or indirectly control or significantly influence the specialist.

.11 When a specialist does not have a relationship with the client, the specialist's work usually will provide the auditor with greater assurance of reliability. However, the work of a specialist who has a relationship with the client may be acceptable under certain circumstances. If the specialist has a relationship with the client, the auditor should assess the risk that the specialist's objectivity might be impaired. If the auditor believes the relationship might impair the specialist's objectivity, the auditor should perform additional procedures with respect to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or should engage another specialist for that purpose.

Using the Findings of the Specialist

.12 The appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist. The auditor should (*a*) obtain an understanding of the methods and assumptions used by the specialist, (*b*) make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk, and (*c*) evaluate whether the specialist's findings support the related assertions in the financial statements. Ordinarily, the auditor would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances. If the auditor believes the findings are unreasonable, he or she should apply additional procedures, which may include obtaining the opinion of another specialist.

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[5] In some cases, the auditor may decide it is necessary to contact the specialist to determine that the specialist is aware that his or her work will be used for evaluating the assertions in the financial statements.

[6] The term *relationship* includes, but is not limited to, those situations discussed in section 334, *Related Parties*, footnote 1.

Effect of the Specialist's Work on the Auditor's Report

.13 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

If the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained. If there is a material difference between the specialist's findings and the assertions in the financial statements, he or she should apply additional procedures. If after applying any additional procedures that might be appropriate the auditor is unable to resolve the matter, the auditor should obtain the opinion of another specialist, unless it appears to the auditor that the matter cannot be resolved. A matter that has not been resolved ordinarily will cause the auditor to conclude that he or she should qualify the opinion or disclaim an opinion because the inability to obtain sufficient appropriate evidential matter as to an assertion of material significance in the financial statements constitutes a scope limitation. (See section 508, *Reports on Audited Financial Statements*, paragraphs .22 and .23.)

.14 The auditor may conclude after performing additional procedures, including possibly obtaining the opinion of another specialist, that the assertions in the financial statements are not in conformity with GAAP. In that event, the auditor should express a qualified or adverse opinion. (See section 508.35, .36, and .41.)

Reference to the Specialist in the Auditor's Report

.15 Except as discussed in paragraph .16, the auditor should not refer to the work or findings of the specialist. Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended. Further, there may be an inference that the auditor making such reference performed a more thorough audit than an auditor not making such reference.

.16 The auditor may, as a result of the report or findings of the specialist, decide to add explanatory language to his or her standard report or depart from an unqualified opinion. Reference to and identification of the specialist may be made in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for the explanatory paragraph or the departure from the unqualified opinion.

Effective Date

.17 This section is effective for audits of periods ending on or after December 15, 1994. Early application of the provisions of this section is encouraged.

AU Section 9336

Using the Work of a Specialist: Auditing Interpretations of Section 336

Source: Auditing Standard Nos. 8–15.

1. The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 140

.01 *Introduction*—Financial Accounting Standards Board (FASB) Statement No. 140,[1] *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, requires that a transferor of financial assets must surrender control over the financial assets to account for the transfer as a sale. Paragraph 9(a) states one of several conditions that must be met to provide evidence of surrender of control:

> The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

Paragraph 27 of FASB Statement No. 140 describes in greater detail the evidence required to support management's assertion that transferred financial assets have been isolated:

> The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or SPE might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any consolidated affiliate of the transferor that is not a special-purpose corporation or other entity designed to make remote the possibility that it would enter bankruptcy or other receivership.

A determination about whether the isolation criterion has been met to support a conclusion regarding surrender of control is largely a matter of law. This aspect of surrender of control, therefore, is assessed primarily from a legal perspective.

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[1] Financial Accounting Standards Board (FASB) Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, is a replacement of FASB Statement No. 125 and is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001, except as provided in paragraphs 19–25 of FASB Statement No. 140 as amended by FASB Technical Bulletin (FTB) No. 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*.

.02 *Effective Date and Applicability*—This interpretation is effective for auditing procedures related to transfers of financial assets that are required to be accounted for under FASB Statement No. 140, as amended by FASB Technical Bulletin (FTB) No. 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*.[2]

.03 *Question*—What should the auditor consider in determining whether to use the work of a legal specialist[3] to obtain persuasive evidence to support management's assertion that a transfer of financial assets meets the isolation criterion of FASB Statement No. 140?

.04 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Interpretation—Section 336, *Using the Work of a Specialist*, paragraph .06, states that "during the audit...an auditor may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain appropriate evidential matter."

.05 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Use of a legal specialist may not be necessary to obtain appropriate evidential matter to support management's assertion that the isolation criterion is met in certain situations, such as when there is a routine transfer of financial assets that does not result in any continuing involvement by the transferor.[4]

.06 Many transfers of financial assets involve complex legal structures, continuing involvement by the transferor, or other legal issues that, in the auditor's judgment, make it difficult to determine whether the isolation criterion is met. In these situations, use of a legal specialist usually is necessary. A legal specialist formulating an opinion as to whether a transfer isolates the transferred assets beyond the reach of the transferor and its creditors may consider, among other things, the structure of the transaction taken as a whole, the nature of any continuing involvement, the type of insolvency or other receivership proceedings to which the transferor might become subject, and other factors pertinent under applicable law.

.07 If a legal opinion is used as evidence to support the accounting conclusion related to multiple transfers under a single structure, and such transfers occur over an extended period of time under that structure, the auditor should evaluate the need for management to obtain periodic updates of that opinion to confirm that there have been no subsequent changes in relevant law or applicable regulations that may change the applicability of the previous opinion

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[2] FTB No. 01-1 amends FASB Statement No. 140 to change the effective date for paragraphs 9(a), 27, 28, and 80–84 of FASB Statement No. 140 for transfers of financial assets by certain financial institutions. Paragraphs 6–8 of FTB No. 01-1 also provide additional transition time for transfers by financial institutions to certain master trusts.

[3] Client's internal or external attorney who is knowledgeable about relevant sections of the U.S. Bankruptcy Code and other federal, state, or foreign laws, as applicable.

[4] FASB Emerging Issues Task Force Topic No. D-99, *Questions and Answers Related to Servicing Activities in a Qualifying Special-Purpose Entity under FASB Statement No. 140*, characterizes *no* continuing involvement with the transferred assets as "no servicing responsibilities, no participation in future cash flows, no recourse obligations other than standard representations and warranties that the financial assets transferred met the delivery requirements under the arrangement, no further involvement of any kind."

If a contractual provision (such as a call or removal of accounts provision) gives the transferor the unilateral ability to require the return of specific financial assets, the auditor should consider the effect of paragraph 9(c) of FASB Statement No. 140.

to such transfers. The auditor also should evaluate the need for management to obtain periodic updates of an opinion to confirm that there have been no subsequent changes in relevant law or applicable regulations that may affect the conclusions reached in the previous opinion in the case of other transfers (see paragraph 55 of FASB Statement No. 140).

.08 If management's assertion with respect to a new transaction is that the transaction structure is the same as a prior structure for which a legal opinion that complies with this interpretation was used as evidence to support an assertion that the transfer of assets met the isolation criterion, the auditor should evaluate the need for management to obtain an update of that opinion to confirm that there have been no changes in relevant law, applicable regulations, or in the pertinent facts of the transaction that may affect the applicability of the previous opinion to the new transaction.

.09 *Question*—If the auditor determines that the use of a legal specialist is required, what should he or she consider in assessing the adequacy of the legal opinion?

.10 *Interpretation*—In assessing the adequacy of the legal opinion, the auditor should consider whether the legal specialist has experience with relevant matters, including knowledge of the U.S. Bankruptcy Code, and other federal, state, or foreign law, as applicable, as well as knowledge of the transaction upon which management's assertion is based. For transactions that may be affected by provisions of the Federal Deposit Insurance Act, the auditor should consider whether the legal specialist has experience with the rights and powers of receivers, conservators, and liquidating agents under that Act. The auditor should obtain an understanding of the assumptions that are used by the legal specialist, and make appropriate tests of any information that management provides to the legal specialist and upon which the specialist indicates it relied. For example, testing management's information underlying a legal specialist's assumption regarding the adequacy of consideration received may depend on the nature of the transaction and the relationship of the parties. When the legal specialist's opinion has assumed the adequacy of consideration for transfers from a particular legal entity to its wholly owned subsidiary, changes in the subsidiary's capital accounts plus other consideration generally would be sufficient audit evidence as to the adequacy of consideration. In the case of other transfers, such as those that are not to a wholly owned subsidiary of a particular legal entity that is the transferor, obtaining additional audit evidence may be necessary to evaluate management's assertion with regard to the adequacy of consideration upon which the legal specialist relied, because changes in the transferee's capital accounts do not solely benefit the transferring entity.

.11 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor also should consider the form and content of the documentation that the legal specialist provides and evaluate whether the legal specialist's findings support management's assertions with respect to the isolation criterion. Section 336.13 states that "if the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained." FASB Statement No. 140's requirement regarding reasonable assurance that the transferred assets would be isolated provides the basis for what auditors should consider in evaluating the work of a legal specialist.

.12 Findings of a legal specialist that relate to the isolation of transferred financial assets are often in the form of a reasoned legal opinion that is restricted to particular facts and circumstances relevant to the specific transaction. The

reasoning of such opinion may rely upon analogy to legal precedents that may not involve facts and circumstances that are comparable to that specific transaction. The auditor also should consider the effect of any limitations or disclaimers of opinion in assessing the adequacy of any legal opinion.

.13 An example of the conclusions in a legal opinion for an entity that is subject to the U.S. Bankruptcy Code that provides persuasive evidence, in the absence of contradictory evidence, to support management's assertion that the transferred financial assets have been put presumptively beyond the reach of the entity and its creditors, even in bankruptcy or other receivership, follows:

> "*We believe (or it is our opinion)that* in a properly presented and argued case, as a legal matter, in the event the Seller were to become a Debtor, the transfer of the Financial Assets from the Seller to the Purchaser *would be considered to be a sale* (or a true sale) of the Financial Assets from the Seller to the Purchaser and not a loan and, accordingly, the Financial Assets and the proceeds thereof transferred to the Purchaser by the Seller in accordance with the Purchase Agreement would not be deemed to be property of the Seller's estate for purposes of [the relevant sections] of the U.S. Bankruptcy Code."

The following additional paragraph addressing substantive consolidation applies when the entity to which the assets are sold (as described in the opinion) is an affiliate of the selling entity and may also apply in other situations as noted by the legal specialist. For example, if a so-called "two-step" structure has been used to achieve isolation, this paragraph usually will be required with respect to the transferee in the first step of such structure (see paragraph .15 and related footnotes for additional guidance on the second step of a two-step structure as described in paragraph 83 of FASB Statement No. 140). When the transferor has entered into transactions with an affiliate that could affect the issue of substantive consolidation, the opinion should address the effect of that involvement on the opinion.

> "Based upon the assumptions of fact and the discussion set forth above, and on a reasoned analysis of analogous case law, *we are of the opinion that* in a properly presented and argued case, as a legal matter, in a proceeding under the U.S. Bankruptcy Code,[5] in which the Seller is a Debtor, a court *would not* grant an order consolidating the assets and liabilities of the Purchaser with those of the Seller in a case involving the insolvency of the Seller under the doctrine of substantive consolidation."

In the case of a transferor that is not entitled to become a debtor under the U.S. Bankruptcy Code, a legal opinion regarding whether the isolation criterion is met would consider whether isolation is satisfactorily achieved under the insolvency or receivership laws that apply to the transferor.

.14 Following are two examples of the conclusions in a legal opinion for an entity that is subject to receivership or conservatorship under provisions of the Federal Deposit Insurance Act. The conclusions in these two examples provide persuasive evidence, in the absence of contradictory evidence, to support management's assertion that the transferred financial assets have been put presumptively beyond the reach of the entity and its creditors, even in conservatorship or receivership. Insolvency and receivership laws applicable to depository institutions, and how those laws affect the legal isolation criterion,

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[5] For an entity subject to additional regulation (e.g., a broker-dealer subject to the Securities Investor Protection Act), the legal opinion also generally should address the effect of such regulation and the policies of the regulators implementing such regulations (e.g., the Securities Investor Protection Corporation).

differ depending upon the nature of the depository institution and its chartering authority. Accordingly, legal opinions addressing the legal isolation criterion may be formulated in different ways to accommodate those differences.[6]

Example 1: "*We believe (or it is our opinion) that* in a properly presented and argued case, as a legal matter, in the event the Seller were to become subject to receivership or conservatorship, the transfer of the Financial Assets from the Seller to the Purchaser *would be considered to be a sale* (or a true sale) of the Financial Assets from the Seller to the Purchaser and not a loan and, accordingly, the Financial Assets and the proceeds thereof transferred to the Purchaser by the Seller in accordance with the Purchase Agreement would not be deemed to be property of, or subject to repudiation, reclamation, recovery, or recharacterization by, the receiver or conservator appointed with respect to the Seller."[7]

Example 2: "The Federal Deposit Insurance Corporation (FDIC) has issued a regulation, 'Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation,' 12 CFR section 360.6 (the Rule). Based on and subject to the discussion, assumptions, and qualifications herein, it is our opinion that:

A. Following the appointment of the FDIC as the conservator or receiver for the Bank:

(i) The Rule will apply to the Transfers,

(ii) Under the Rule, the FDIC acting as conservator or receiver for the Bank could not, by exercise of its authority to disaffirm or repudiate contracts under 12 U.S.C. § 1821(e), reclaim or recover the Transferred Assets from the Issuer or recharacterize the Transferred Assets as property of the Bank or of the conservatorship or receivership for the Bank,

(iii) Neither the FDIC (acting for itself as a creditor or as representative of the Bank or its shareholders or creditors) nor any creditor of the Bank would have the right, under any bankruptcy or insolvency law applicable in the conservatorship or receivership of the Bank, to avoid the Transfers, to recover the Transferred Assets, or to require the Transferred Assets to be turned over to the FDIC or such creditor, and

(iv) There is no other power exercisable by the FDIC as conservator or receiver for the Bank that would permit the FDIC as such conservator or receiver to reclaim or recover the Transferred Assets from the Issuer, or to recharacterize the Transferred

[6] For an entity subject to conservatorship or liquidation under the National Credit Union Act, the examples and discussion in this paragraph would be modified to make appropriate references to "liquidation" and "liquidating agent" and additional information relating to rights and regulations of the National Credit Union Administration.

[7] When the opinion indicates that isolation is achieved without reference to a true sale, the opinion also should provide reasonable assurance that the transferred assets are beyond the reach of the transferor and its creditors other than the transferee to the same extent that is provided in example 2, paragraph B.

Assets as property of the Bank or of the conservatorship or receivership for the Bank; provided, however, that we offer no opinion as to whether, in receivership, the FDIC or any creditor of the Bank may take any such actions if the Holders [*holders of beneficial interests in the transferred assets*] receive payment of the principal amount of the Interests and the interest earned thereon (at the contractual yield) through the date the Holders are so paid; and

B. Prior to the appointment of the FDIC as conservator or receiver for the Bank, the Bank and its other creditors would not have the right to reclaim or recover the Transferred Assets from the Issuer, except by the exercise of a contractual provision [insert appropriate citation] to require the transfer, or return, of the Transferred Assets that exists solely as a result of the contract between the Bank and the Issuer." [8]

The following additional paragraph addressing substantive consolidation applies when the entity to which the assets are sold or transferred (as described in the opinion) is an affiliate of the selling entity and may also apply in other situations as noted by the legal specialist.[9] For example, if a so-called two-step structure has been used to achieve isolation, the following paragraph usually will be required with respect to the transferee in the first step of the structure (see paragraph .15 and related footnotes for additional guidance on the second step of a two-step structure as described in paragraph 83 of FASB Statement No. 140). When the transferor has entered into transactions with an affiliate that could affect the issue of substantive consolidation, the opinion should address the effect of that involvement on the opinion.

"Based upon the assumptions of fact and the discussion set forth above, and on a reasoned analysis of analogous case law, *we are of the opinion that* in a properly presented and argued case, as a legal matter, in a receivership, conservatorship, or liquidation proceeding in respect of the Seller, a court *would not* grant an order consolidating the assets and liabilities of the Purchaser with those of the Seller."

Certain powers to repudiate contracts, recover, reclaim, or recharacterize transferred assets as property of a transferor that are exercisable by the FDIC under the Federal Deposit Insurance Act may, as of the date of the transfer, be limited by a regulation that may be repealed or amended only in respect of transfers occurring on or after the effective date of such repeal or amendment.[10] With respect to the powers of a receiver or conservator that may not be exercised under that regulation, it is acceptable for attorneys to rely upon the effectiveness of the limitation on such powers set forth in the applicable regulation, provided that the attorney states, based on reasonable assumptions, that: (1) the affected transfer of financial assets meets all qualification requirements of the regulation, and (2) the regulation had not, as of the date of the

[8] See the second paragraph of footnote 4.

Paragraph B is not required if the opinion includes both a conclusion, as set forth in example 1, that the transfer constitutes a "true sale" and the conclusions set forth of example 2, paragraph A. It is not necessary to include any provision of example 2 if the opinion is as set forth in example 1.

[9] An additional substantive consolidation opinion is not required if the opinion states that its conclusion includes the inability to recover the transferred financial assets or recharacterize the transfer by application of the doctrine of "substantive consolidation."

[10] The applicable regulation is 12 CFR section 360.6, effective September 11, 2000.

opinion, been amended, repealed, or held inapplicable by a court with jurisdiction with respect to such transfer. The opinion should separately address any powers of repudiation, recovery, reclamation, or recharacterization exercisable by a receiver or conservator notwithstanding that regulation (for example, rights, powers, or remedies regarding transfers specifically excluded from the regulation) in a manner that provides the same level of assurance as would be provided in the case of opinions that conform with requirements of paragraph .13, except that such opinion shall address powers arising under the Federal Deposit Insurance Act. The considerations in the immediately preceding three sentences are adequately addressed either by the example 1 opinion or the example 2 opinion described in this paragraph or by the variations described in the second paragraph of footnote 8 and in footnote 9.

.15 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

A legal letter that includes an inadequate opinion, inappropriate limitations, or a disclaimer of opinion, or that effectively limits the scope of the opinion to facts and circumstances that are not applicable to the transaction, does not provide persuasive evidence to support the entity's assertion that the transferred assets have been put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. Likewise, a legal letter that includes conclusions that are expressed using some of the following language would not provide persuasive evidence that a transfer of financial assets has met the isolation criterion of FASB Statement No. 140 (see paragraphs .20 and .21 of this interpretation):

- "We are unable to express an opinion..."
- "It is our opinion, based upon limited facts..."
- "We are of the view..." or "it appears..."
- "There is a reasonable basis to conclude that..."
- "In our opinion, the transfer would *either* be a sale *or* a grant of a perfected security interest..."[11]
- "In our opinion, there is a reasonable possibility..."
- "In our opinion, the transfer *should* be considered a sale..."
- "It is our opinion that the company will be able to assert meritorious arguments..."
- "In our opinion, it is more likely than not ..."
- "In our opinion, the transfer would *presumptively* be..."
- "In our opinion, it is probable that..."

Furthermore, conclusions about hypothetical transactions may not be relevant to the transaction that is the subject of management's assertions. Paragraph 6

[11] Certain transferors are subject only to receivership (and not to proceedings under the U.S. Bankruptcy Code or the Federal Deposit Insurance Act) under laws that do not allow a receiver to reach assets in which a security interest has been granted. In such circumstances, an opinion that concludes that the transfer would either be a sale or a grant of a security interest that puts the transferred assets beyond the reach of such receiver and other creditors would provide persuasive evidence that the isolation criterion is met. In certain circumstances, a legal specialist may provide an opinion on both steps of a two-step structure. Such language would be acceptable in an opinion for a transfer of assets in the second step of a two-step structure as described in paragraph 83 of FASB Statement No. 140 provided that the opinion on the transfer in the first step is consistent with paragraphs .13 or .14 of this interpretation.

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." Additionally, conclusions about hypothetical transactions may not contemplate all of the facts and circumstances or the provisions in the agreements of the transaction that is the subject of management's assertions, and generally would not provide persuasive evidence.[12]

.16 *Question*—Are legal opinions that restrict the use of the opinion to the client, or to third parties other than the auditor, acceptable audit evidence?

.17 *Interpretation*—No. Footnote 5 to section 336.09 states: "In some cases, the auditor may decide it is necessary to contact the specialist to determine that the specialist is aware that his or her work will be used for evaluating the assertions in the financial statements." Given the importance of the legal opinion to the assertion in this case, and the precision that legal specialists use in drafting such opinions, an auditor should not use as evidence a legal opinion that he or she deems otherwise adequate if the letter restricts use of the findings expressed therein to the client or to third parties other than the auditor. In that event, the auditor should request that the client obtain the legal specialist's written permission for the auditor to use the opinion for the purpose of evaluating management's assertion that a transfer of financial assets meets the isolation criterion of FASB Statement No. 140.

.18 An example of a letter from a legal specialist to a client that adequately communicates permission for the auditor to use the legal specialist's opinion for the purpose of evaluating management's assertion that a transfer of financial assets meets the isolation criterion of FASB Statement No. 140 is as follows:

> "Notwithstanding any language to the contrary in our opinions of even date with respect to certain bankruptcy issues relating to the above-referenced transaction, you are authorized to make available to your auditors such opinions solely as evidential matter in support of their evaluation of management's assertion that the transfer of the receivables meets the isolation criterion of FASB Statement No. 140, provided a copy of this letter is furnished to them in connection therewith. In authorizing you to make copies of such opinions available to your auditors for such purpose, we are not undertaking or assuming any duty or obligation to your auditors or establishing any lawyer-client relationship with them. Further, we do not undertake or assume any responsibility with respect to financial statements of you or your affiliates."[13]

.19 A letter from a legal specialist to a client might authorize the client to make copies of the legal opinion available to the auditor to use in his or her evaluation of management's assertion that a transfer of financial assets meets the isolation criterion of FASB Statement No. 140, but then state that the auditor is not authorized to rely thereon. Such "use but not rely on" language, or other language that similarly restricts the auditor's use of the legal specialist's opinion, does not adequately communicate permission for the auditor to use the legal specialist's opinion as evidential matter. The auditor may wish to consult with his or her legal counsel in circumstances where it is not clear that the auditor may use the legal specialist's opinion.

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[12] For example, a memorandum of law from a legal specialist usually analyzes (and may make conclusions about) a transaction that may be completed subsequently. Such memorandum generally would not provide persuasive evidence unless the conclusions conform with this interpretation and a legal specialist opines that such conclusions apply to a completed transaction that is the subject of management's assertion.

[13] This language may appear in the legal specialist's opinion rather than in a separate letter. In that case, the wording would be modified slightly to indicate the context.

.20 *Question*—If the auditor determines that it is appropriate to use the work of a legal specialist, and either the resulting legal response does not provide persuasive evidence that a transfer of assets has met the isolation criterion, or the legal specialist does not grant permission for the auditor to use a legal opinion that is restricted to the client or to third parties other than the auditor, what other steps might an auditor consider?

.21 *Interpretation*—When other relevant evidential matter exists, the auditor should consider it before reaching a conclusion about the appropriateness of management's accounting for a transfer.[14] However, since the isolation aspect of surrender of control is assessed primarily from a legal perspective, the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion. In the absence of persuasive evidence that a transfer has met the isolation criterion, derecognition of the transferred assets is not in conformity with generally accepted accounting principles and the auditor should consider the need to express a qualified or adverse opinion in accordance with section 508, *Reports on Audited Financial Statements*, paragraphs .35 through .60. However, if permission for the auditor to use a legal opinion that he or she deems otherwise adequate is not granted, this would be a scope limitation and the auditor should consider the need to express a qualified opinion or to disclaim an opinion in accordance with section 508.22–.26 and 508.61–.63.

[Issue Date: December, 2001.]

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[14] See section 336.13 as to additional procedures that may be applied.

AU Section 337

Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments[1]

Source: SAS No. 12.

See section 9337 for interpretations of this section.

Issue date, unless otherwise indicated: January, 1976.

.01 This section provides guidance on the procedures an independent auditor should consider for identifying litigation, claims, and assessments and for satisfying himself as to the financial accounting and reporting for such matters when he is performing an audit in accordance with generally accepted auditing standards.

Accounting Considerations

.02 Management is responsible for adopting policies and procedures to identify, evaluate, and account for litigation, claims, and assessments as a basis for the preparation of financial statements in conformity with generally accepted accounting principles.

.03 The standards of financial accounting and reporting for loss contingencies, including those arising from litigation, claims, and assessments, are set forth in Statement of Financial Accounting Standards No. 5 [AC section C59], *Accounting for Contingencies*.[2]

Auditing Considerations

.04 With respect to litigation, claims, and assessments, the independent auditor should obtain evidential matter relevant to the following factors:

a. The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments.

b. The period in which the underlying cause for legal action occurred.

c. The degree of probability of an unfavorable outcome.

d. The amount or range of potential loss.

Audit Procedures

.05 Since the events or conditions that should be considered in the financial accounting for and reporting of litigation, claims, and assessments are matters

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[1] This section supersedes the commentary, "Lawyers' Letters," January 1974 (section 1001), and auditing interpretations of section 560.12 on lawyers' letters, January 1975 (section 9560.01-.26). It amends section 560.12(*d*) to read as follows: "Inquire of client's legal counsel concerning litigation, claims, and assessments (see section 337)."

[2] Pertinent portions are reprinted in Exhibit I, section 337B. FASB Statement No. 5 [AC section C59], also describes the standards of financial accounting and reporting for gain contingencies. The auditor's procedures with respect to gain contingencies are parallel to those described in this SAS for loss contingencies.

within the direct knowledge and, often, control of management of an entity, management is the primary source of information about such matters. Accordingly, the independent auditor's procedures with respect to litigation, claims, and assessments should include the following:

a. Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.

b. Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel, and obtain assurances from management, ordinarily in writing, that they have disclosed all such matters required to be disclosed by Statement of Financial Accounting Standards No. 5 [AC section C59].

c. Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.

d. Obtain assurance from management, ordinarily in writing, that it has disclosed all unasserted claims that the lawyer has advised them are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59]. Also the auditor, with the client's permission, should inform the lawyer that the client has given the auditor this assurance. This client representation may be communicated by the client in the inquiry letter or by the auditor in a separate letter.[3]

.06 An auditor ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to his attention. Accordingly, the auditor should request the client's management to send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments.

.07 The audit normally includes certain other procedures undertaken for different purposes that might also disclose litigation, claims, and assessments. Examples of such procedures are as follows:

a. Reading minutes of meetings of stockholders, directors, and appropriate committees held during and subsequent to the period being audited.

b. Reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies, and similar documents.

c. Obtaining information concerning guarantees from bank confirmation forms.

d. Inspecting other documents for possible guarantees by the client.

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[3] An example of a separate letter is as follows: We are writing to inform you that (name of company) has represented to us that (except as set forth below and excluding any such matters listed in the letter of audit inquiry) there are no unasserted possible claims that you have advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59] in its financial statements at (balance sheet date) and for the (period) then ended. (List unasserted possible claims, if any.) Such a letter should be signed and sent by the auditor.

Inquiry of a Client's Lawyer[4]

.08 A letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments.[5] Evidential matter obtained from the client's inside general counsel or legal department may provide the auditor with the necessary corroboration. However, evidential matter obtained from inside counsel is not a substitute for information outside counsel refuses to furnish.

.09 The matters that should be covered in a letter of audit inquiry include, but are not limited to, the following:

a. Identification of the company, including subsidiaries, and the date of the audit.

b. A list prepared by management (or a request by management that the lawyer prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation.

c. A list prepared by management that describes and evaluates unasserted claims and assessments that management considers to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome, with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation.

d. As to each matter listed in item *b*, a request that the lawyer either furnish the following information or comment on those matters as to which his views may differ from those stated by management, as appropriate:

(1) A description of the nature of the matter, the progress of the case to date, and the action the company intends to take (for example, to contest the matter vigorously or to seek an out-of-court settlement).

(2) An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.

(3) With respect to a list prepared by management, an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

e. As to each matter listed in item *c*, a request that the lawyer comment on those matters as to which his views concerning the description or evaluation of the matter may differ from those stated by management.

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[4] An illustrative inquiry letter to legal counsel is contained in the Appendix (section 337A).

[5] It is not intended that the lawyer be requested to undertake a reconsideration of all matters upon which he was consulted during the period under audit for the purpose of determining whether he can form a conclusion regarding the probability of assertion of any possible claim inherent in any of the matters so considered.

f. A statement by the client that the client understands that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client should disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5 [AC section C59].

g. A request that the lawyer confirm whether the understanding described in item *f* is correct.

h. A request that the lawyer specifically identify the nature of and reasons for any limitation on his response.

Inquiry need not be made concerning matters that are not considered material, provided the client and the auditor have reached an understanding on the limits of materiality for this purpose.

.10 In special circumstances, the auditor may obtain a response concerning matters covered by the audit inquiry letter in a conference, which offers an opportunity for a more detailed discussion and explanation than a written reply. A conference may be appropriate when the evaluation of the need for accounting for or disclosure of litigation, claims, and assessments involves such matters as the evaluation of the effect of legal advice concerning unsettled points of law, the effect of uncorroborated information, or other complex judgments. The auditor should appropriately document conclusions reached concerning the need for accounting for or disclosure of litigation, claims, and assessments.

.11 In some circumstances, a lawyer may be required by his Code of Professional Responsibility to resign his engagement if his advice concerning financial accounting and reporting for litigation, claims, and assessments is disregarded by the client. When the auditor is aware that a client has changed lawyers or that a lawyer engaged by the client has resigned, the auditor should consider the need for inquiries concerning the reasons the lawyer is no longer associated with the client.

Limitations on the Scope of a Lawyer's Response[6]

.12 A lawyer may appropriately limit his response to matters to which he has given substantive attention in the form of legal consultation or representation. Also, a lawyer's response may be limited to matters that are considered individually or collectively material to the financial statements, provided the lawyer and auditor have reached an understanding on the limits of materiality for this purpose. Such limitations are not limitations on the scope of the audit.

.13 A lawyer's refusal to furnish the information requested in an inquiry letter either in writing or orally (see paragraphs .09 and .10) would be a limitation on the scope of the audit sufficient to preclude an unqualified opinion

[6] The American Bar Association has approved a "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information," which explains the concerns of lawyers and the nature of the limitations an auditor is likely to encounter. That Statement of Policy is reprinted as Exhibit II (section 337C) for the convenience of readers, but is not an integral part of this Statement.

(see section 508.22 and .23).[7] A lawyer's response to such an inquiry and the procedures set forth in paragraph .05 provide the auditor with sufficient evidential matter to satisfy himself concerning the accounting for and reporting of pending and threatened litigation, claims and assessments. The auditor obtains sufficient evidential matter to satisfy himself concerning reporting for those unasserted claims and assessments required to be disclosed in financial statements from the foregoing procedures and the lawyer's specific acknowledgement of his responsibility to his client in respect of disclosure obligations (see paragraph .09*g*). This approach with respect to unasserted claims and assessments is necessitated by the public interest in protecting the confidentiality of lawyer-client communications.

Other Limitations on a Lawyer's Response

.14 A lawyer may be unable to respond concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount or range of potential loss, because of inherent uncertainties. Factors influencing the likelihood of an unfavorable outcome may sometimes not be within a lawyer's competence to judge; historical experience of the entity in similar litigation or the experience of other entities may not be relevant or available; and the amount of the possible loss frequently may vary widely at different stages of litigation. Consequently, a lawyer may not be able to form a conclusion with respect to such matters. In such circumstances, the auditor ordinarily will conclude that the financial statements are affected by an uncertainty concerning the outcome of a future event which is not susceptible of reasonable estimation, and should look to the guidance in section 508.45 through .49 to determine the effect, if any, of the lawyer's response on the auditor's report. [Revised, February 1997, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 79.]

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[7] A refusal to respond should be distinguished from an inability to form a conclusion with respect to certain matters of judgment (see paragraph .14). Also, lawyers outside the United States sometimes follow practices at variance with those contemplated by this section to the extent that different procedures from those outlined herein may be necessary. In such circumstances, the auditor should exercise judgment in determining whether alternative procedures are adequate to comply with the requirements of this section.

AU Section 337A

Appendix—Illustrative Audit Inquiry Letter to Legal Counsel

Source: SAS No. 12.

Issue date, unless otherwise indicated: January, 1976.

.01 In connection with an audit of our financial statements at (balance sheet date) and for the (period) then ended, management of the Company has prepared, and furnished to our auditors (name and address of auditors), a description and evaluation of certain contingencies, including those set forth below involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. These contingencies are regarded by management of the Company as material for this purpose (management may indicate a materiality limit if an understanding has been reached with the auditor). Your response should include matters that existed at (balance sheet date) and during the period from that date to the date of your response.

Pending or Threatened Litigation (excluding unasserted claims)

[Ordinarily the information would include the following: (1) the nature of the litigation, (2) the progress of the case to date, (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.] Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

Unasserted Claims and Assessments (considered by management to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome)

[Ordinarily management's information would include the following: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.] Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial

Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the company, such as guarantees of indebtedness of others.]

AU Section 337B

Exhibit I—Excerpts from Statement of Financial Accounting Standards No. 5: Accounting for Contingencies

Source: SAS No. 12.

March, 1975.

The following excerpts are reprinted with the permission of the Financial Accounting Standards Board.

Introduction

1. For the purpose of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a "gain contingency") or loss[1] (hereinafter a "loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability. . . .

3. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:

a. *Probable.* The future event or events are likely to occur.

b. *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.

c. *Remote.* The chance of the future event or events occurring is slight. . . .

Standards of Financial Accounting and Reporting

Accrual of Loss Contingencies

8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income[3] if *both* of the following conditions are met:

a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or

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[1] The term *loss* is used for convenience to include many charges against income that are commonly referred to as *expenses* and others that are commonly referred to as *losses.*

[3] [Superseded, effective for financial statements for fiscal years beginning after October 15, 1977, by FASB Statement No. 16.]

a liability had been incurred at the date of the financial statements.[4] It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b. The amount of loss can be reasonably estimated.

Disclosure of Loss Contingencies

9. Disclosure of the nature of an accrual[5] made pursuant to the provisions of paragraph 8, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.

10. If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.[6] The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

11. After the date of an enterprise's financial statements but before those financial statements are issued, information may become available indicating that an asset was impaired or a liability was incurred after the date of the financial statements or that there is at least a reasonable possibility that an asset was impaired or a liability was incurred after that date. The information may relate to a loss contingency that existed at the date of the financial statements, e.g., an asset that was not insured at the date of the financial statements. On the other hand, the information may relate to a loss contingency that did not exist at the date of the financial statements, e.g., threat of expropriation of assets after the date of the financial statements or the filing for bankruptcy by an enterprise whose debt was guaranteed after the date of the financial statements. In none of the cases cited in this paragraph was an asset impaired or a liability incurred at the date of the financial statements, and the condition for accrual in paragraph 8(*a*) is, therefore, not met. Disclosure of those kinds of losses or loss contingencies may be necessary, however, to keep the financial statements from being misleading. If disclosure is deemed necessary, the financial statements shall indicate the nature of the loss or loss contingency and give an estimate of the amount or range of loss or possible loss or state that such an estimate cannot be made. Occasionally, in the case of a loss arising after the date of the financial statements where the amount of asset impairment or liability incurrence

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[4] *Date of the financial statements* means the end of the most recent accounting period for which financial statements are being presented.

[5] Terminology used shall be descriptive of the nature of the accrual (see paragraphs 57-64 of *Accounting Terminology Bulletin No. 1*, "Review and Resume").

[6] For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 8(*a*) but that is not accrued because the amount of loss cannot be reasonably estimated (paragraph 8(*b*)). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 8(*a*)—namely, those contingencies for which there is a *reasonable possibility* that a loss may have been incurred even though information may not indicate that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements.

can be reasonably estimated, disclosure may best be made by supplementing the historical financial statements with pro forma financial data giving effect to the loss as if it had occurred at the date of the financial statements. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical financial statements. . . .

Litigation, Claims, and Assessments

33. The following factors, among others, must be considered in determining whether accrual and/or disclosure is required with respect to pending or threatened litigation and actual or possible claims and assessments:

a. The period in which the underlying cause (i.e., the cause for action) of the pending or threatened litigation or of the actual or possible claim or assessment occurred.

b. The degree of probability of an unfavorable outcome.

c. The ability to make a reasonable estimate of the amount of loss.

34. As a condition for accrual of a loss contingency, paragraph 8(*a*) requires that information available prior to the issuance of financial statements indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Accordingly, accrual would clearly be inappropriate for litigation, claims, or assessments whose underlying cause is an event or condition occurring after the date of financial statements but before those financial statements are issued, for example, a suit for damages alleged to have been suffered as a result of an accident that occurred after the date of the financial statements. Disclosure may be required, however, by paragraph 11.

35. On the other hand, accrual may be appropriate for litigation, claims, or assessments whose underlying cause is an event occurring on or before the date of an enterprise's financial statements even if the enterprise does not become aware of the existence or possibility of the lawsuit, claim, or assessment until after the date of the financial statements. If those financial statements have not been issued, accrual of a loss related to the litigation, claim, or assessment would be required if the probability of loss is such that the condition in paragraph 8(*a*) is met and the amount of loss can be reasonably estimated.

36. If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an enterprise's financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition in paragraph 8(*a*) is met. Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise's management as to how the enterprise intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement). The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss in paragraph 8(*a*) is met.

37. The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for

accrual in paragraph 8(*a*) would be met if an unfavorable outcome is determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10 of this Statement.

38. With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise's patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8. If an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, accrual would not be appropriate, but disclosure would be required by paragraph 10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph 10.

39. As a condition for accrual of a loss contingency, paragraph 8(*b*) requires that the amount of loss can be reasonably estimated. In some cases, it may be determined that a loss was incurred because an unfavorable outcome of the litigation, claim, or assessment is probable (thus satisfying the condition in paragraph 8(*a*)), but the range of possible loss is wide. For example, an enterprise may be litigating an income tax matter. In preparation for the trial, it may determine that, based on recent decisions involving one aspect of the litigation, it is probable that it will have to pay additional taxes of $2 million. Another aspect of the litigation may, however, be open to considerable interpretation, and depending on the interpretation by the court the enterprise may have to pay taxes of $8 million over and above the $2 million. In that case, paragraph 8 requires accrual of the $2 million if that is considered a reasonable estimate of the loss. Paragraph 10 requires disclosure of the additional exposure to loss if there is a reasonable possibility that additional taxes will be paid. Depending on the circumstances, paragraph 9 may require disclosure of the $2 million that was accrued.

AU Section 337C

Exhibit II—American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information

Note: This document, in the form herein set forth, was approved by the Board of Governors of the American Bar Association in December 1975, which official action permitted its release to lawyers and accountants as the standard recommended by the American Bar Association for the lawyer's response to letters of audit inquiry.

Source: SAS No. 12.

Preamble

The public interest in protecting the confidentiality of lawyer-client communications is fundamental. The American legal, political and economic systems depend heavily upon voluntary compliance with the law and upon ready access to a respected body of professionals able to interpret and advise on the law. The expanding complexity of our laws and governmental regulations increases the need for prompt, specific and unhampered lawyer-client communication. The benefits of such communication and early consultation underlie the strict statutory and ethical obligations of the lawyer to preserve the confidences and secrets of the client, as well as the long-recognized testimonial privilege for lawyer-client communication.

Both the Code of Professional Responsibility and the cases applying the evidentiary privilege recognize that the privilege against disclosure can be knowingly and voluntarily waived by the client. It is equally clear that disclosure to a third party may result in loss of the "confidentiality" essential to maintain the privilege. Disclosure to a third party of the lawyer-client communication on a particular subject may also destroy the privilege as to other communications on that subject. Thus, the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and client may significantly impair the client's ability in other contexts to maintain the confidentiality of such communications.

Under the circumstances a policy of audit procedure which requires clients to give consent and authorize lawyers to respond to general inquiries and disclose information to auditors concerning matters which have been communicated in confidence is essentially destructive of free and open communication and early consultation between lawyer and client. The institution of such a policy would inevitably discourage management from discussing potential legal problems with counsel for fear that such discussion might become public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.

It is also recognized that our legal, political and economic systems depend to an important extent on public confidence in published financial statements.

To meet this need the accounting profession must adopt and adhere to standards and procedures that will command confidence in the auditing process. It is not, however, believed necessary, or sound public policy, to intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence. On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between lawyer and client, thereby strengthening corporate management's confidence in counsel and encouraging its readiness to seek advice of counsel and to act in accordance with counsel's advice.

Consistent with the foregoing public policy considerations, it is believed appropriate to distinguish between, on the one hand, litigation which is pending or which a third party has manifested to the client a present intention to commence and, on the other hand, other contingencies of a legal nature or having legal aspects. As regards the former category, unquestionably the lawyer representing the client in a litigation matter may be the best source for a description of the claim or claims asserted, the client's position (e.g., denial, contest, etc.), and the client's possible exposure in the litigation (to the extent the lawyer is in a position to do so). As to the latter category, it is submitted that, for the reasons set forth above, it is not in the public interest for the lawyer to be required to respond to general inquiries from auditors concerning possible claims.

It is recognized that the disclosure requirements for enterprises subject to the reporting requirements of the Federal securities laws are a major concern of managements and counsel, as well as auditors. It is submitted that compliance therewith is best assured when clients are afforded maximum encouragement, by protecting lawyer-client confidentiality, freely to consult counsel. Likewise, lawyers must be keenly conscious of the importance of their clients being competently advised in these matters.

Statement of Policy

NOW, THEREFORE, BE IT RESOLVED that it is desirable and in the public interest that this Association adopt the following Statement of Policy regarding the appropriate scope of the lawyer's response to the auditor's request, made by the client at the request of the auditor, for information concerning matters referred to the lawyer during the course of his representation of the client:

(1) *Client Consent to Response.* The lawyer may properly respond to the auditor's requests for information concerning loss contingencies (the term and concept established by Statement of Financial Accounting Standards No. 5, promulgated by the Financial Accounting Standards Board in March 1975 and discussed in Paragraph 5.1 of the accompanying Commentary), to the extent hereinafter set forth, subject to the following:

a. Assuming that the client's initial letter requesting the lawyer to provide information to the auditor is signed by an agent of the client having apparent authority to make such a request, the lawyer may provide to the auditor information requested, without further consent, unless such information discloses a confidence or a secret or requires an evaluation of a claim.

b. In the normal case, the initial request letter does not provide the necessary consent to the disclosure of a confidence or secret or to the evaluation of a claim since that consent may only be given after full disclosure to the client of the legal consequences of such action.

c. Lawyers should bear in mind, in evaluating claims, that an adverse party may assert that any evaluation of potential liability is an admission.

d. In securing the client's consent to the disclosure of confidences or secrets, or the evaluation of claims, the lawyer may wish to have a draft of his letter reviewed and approved by the client before releasing it to the auditor; in such cases, additional explanation would in all probability be necessary so that the legal consequences of the consent are fully disclosed to the client.

(2) *Limitation on Scope of Response.* It is appropriate for the lawyer to set forth in his response, by way of limitation, the scope of his engagement by the client. It is also appropriate for the lawyer to indicate the date as of which information is furnished and to disclaim any undertaking to advise the auditor of changes which may thereafter be brought to the lawyer's attention. *Unless the lawyer's response indicates otherwise, (a) it is properly limited to matters which have been given substantive attention by the lawyer in the form of legal consultation and, where appropriate, legal representation since the beginning of the period or periods being reported upon, and (b) if a law firm or a law department, the auditor may assume that the firm or department has endeavored, to the extent believed necessary by the firm or department, to determine from lawyers currently in the firm or department who have performed services for the client since the beginning of the fiscal period under audit whether such services involved substantive attention in the form of legal consultation concerning those loss contingencies referred to in Paragraph 5(a) below but, beyond that, no review has been made of any of the client's transactions or other matters for the purpose of identifying loss contingencies to be described in the response.*[*]

(3) *Response may be Limited to Material Items*. In response to an auditor's request for disclosure of loss contingencies of a client, it is appropriate for the lawyer's response to indicate that the response is limited to items which are considered individually or collectively material to the presentation of the client's financial statements.

(4) *Limited Responses*. Where the lawyer is limiting his response in accordance with the Statement of Policy, his response should so indicate (see Paragraph 8). If in any other respect the lawyer is not undertaking to respond to or comment on particular aspects of the inquiry when responding to the auditor, he should consider advising the auditor that his response is limited, in order to avoid any inference that the lawyer has responded to all aspects; otherwise, he may be assuming a responsibility which he does not intend.

(5) *Loss Contingencies*. When properly requested by the client, it is appropriate for the lawyer to furnish to the auditor information concerning the following matters if the lawyer has been engaged by the client to represent or advise the client professionally with

[*] As contemplated by Paragraph 8 of this Statement of Policy, this sentence is intended to be the subject of incorporation by reference as therein provided.

respect thereto and he has devoted substantive attention to them in the form of legal representation or consultation:

a. *overtly threatened or pending litigation*, whether or not specified by the client;

b. *a contractually assumed obligation* which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor;

c. *an unasserted possible claim or assessment* which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor.

With respect to clause (*a*), overtly threatened litigation means that a potential claimant has manifested to the client an awareness of and present intention to assert a possible claim or assessment unless the likelihood of litigation (or of settlement when litigation would normally be avoided) is considered remote. With respect to clause (*c*), where there has been no manifestation by a potential claimant of an awareness of and present intention to assert a possible claim or assessment, consistent with the considerations and concerns outlined in the Preamble and Paragraph 1 hereof, the client should request the lawyer to furnish information to the auditor only if the client has determined that it is probable that a possible claim will be asserted, that there is a reasonable possibility that the outcome (assuming such assertion) will be unfavorable, and that the resulting liability would be material to the financial condition of the client. Examples of such situations might (depending in each case upon the particular circumstances) include the following: (i) a catastrophe, accident or other similar physical occurrence in which the client's involvement is open and notorious, or (ii) an investigation by a government agency where enforcement proceedings have been instituted or where the likelihood that they will not be instituted is remote, under circumstances where assertion of one or more private claims for redress would normally be expected, or (iii) a public disclosure by the client acknowledging (and thus focusing attention upon) the existence of one or more probable claims arising out of an event or circumstance. In assessing whether or not the assertion of a possible claim is probable, it is expected that the client would normally employ, by reason of the inherent uncertainties involved and insufficiency of available data, concepts parallel to those used by the lawyer (discussed below) in assessing whether or not an unfavorable outcome is probable; thus, assertion of a possible claim would be considered probable only when the prospects of its being asserted seem reasonably certain (i.e., supported by extrinsic evidence strong enough to establish a presumption that it will happen) and the prospects of nonassertion seem slight.

It would not be appropriate, however, for the lawyer to be requested to furnish information in response to an inquiry letter or supplement thereto if it appears that (*a*) the client has been required to specify unasserted possible claims without regard to the standard suggested in the preceding paragraph, or (*b*) the client has been required to specify all or substantially all unasserted possible claims as to which legal advice may have been obtained,

since, in either case, such a request would be in substance a general inquiry and would be inconsistent with the intent of this Statement of Policy.

The information that lawyers may properly give to the auditor concerning the foregoing matters would include (to the extent appropriate) an identification of the proceedings or matter, the stage of proceedings, the claim(s) asserted, and the position taken by the client.

In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either "probable" or "remote"; for purposes of any such judgment it is appropriate to use the following meanings:

(i) *probable*—an unfavorable outcome for the client is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight.

(ii) *remote*—an unfavorable outcome is remote if the prospects for the client not succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight.

If, in the opinion of the lawyer, considerations within the province of his professional judgment bear on a particular loss contingency to the degree necessary to make an informed judgment, he may in appropriate circumstances communicate to the auditor his view that an unfavorable outcome is "probable" or "remote," applying the above meanings. No inference should be drawn, from the absence of such a judgment, that the client will not prevail.

The lawyer also may be asked to estimate, in dollar terms, the potential amount of loss or range of loss in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss (if the outcome should be unfavorable) only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight.

The considerations bearing upon the difficulty in estimating loss (or range of loss) where pending litigation is concerned are obviously even more compelling in the case of unasserted possible claims. In most cases, the lawyer will not be able to provide any such estimate to the auditor.

As indicated in Paragraph 4 hereof, the auditor may assume that all loss contingencies specified by the client in the manner specified in clauses (*b*) and (*c*) above have received comment in the response, unless otherwise therein indicated. The lawyer should not be asked, nor need the lawyer undertake, to furnish information to the auditor concerning loss contingencies except as contemplated by this Paragraph 5.

(6) *Lawyer's Professional Responsibility.* Independent of the scope of his response to the auditor's request for information, the lawyer,

depending upon the nature of the matters as to which he is engaged, may have as part of his professional responsibility to his client an obligation to advise the client concerning the need for or advisability of public disclosure of a wide range of events and circumstances. The lawyer has an obligation not knowingly to participate in any violation by the client of the disclosure requirements of the securities laws. In appropriate circumstances, the lawyer also may be required under the Code of Professional Responsibility to resign his engagement if his advice concerning disclosures is disregarded by the client. The auditor may properly assume that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment which may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client must disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements[†] of FAS 5.

(7) *Limitation on Use of Response. Unless otherwise stated in the lawyer's response, it shall be solely for the auditor's information in connection with his audit of the financial condition of the client and is not to be quoted in whole or in part or otherwise referred to in any financial statements of the client or related documents, nor is it to be filed with any governmental agency or other person, without the lawyer's prior written consent.*[‡] *Notwithstanding such limitation, the response can properly be furnished to others in compliance with court process or when necessary in order to defend the auditor against a challenge of the audit by the client or a regulatory agency, provided that the lawyer is given written notice of the circumstances at least twenty days before the response is so to be furnished to others, or as long in advance as possible if the situation does not permit such period of notice.*[‡]

(8) *General.* This Statement of Policy, together with the accompanying Commentary (which is an integral part hereof), has been developed for the general guidance of the legal profession. In a particular case, the lawyer may elect to supplement or modify the approach hereby set forth. If desired, this Statement of Policy may be incorporated by reference in the lawyer's response by the following statement: "This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any 'loss contingencies' is qualified

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[†] Under FAS 5, when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment, disclosure of an unasserted possible claim is required only if the enterprise concludes that (i) it is probable that a claim will be asserted, (ii) there is a reasonable possibility, if the claim is in fact asserted, that the outcome will be unfavorable, and (iii) the liability resulting from such unfavorable outcome would be material to its financial condition.

[‡] As contemplated by Paragraph 8 of this Statement of Policy, this sentence is intended to be the subject of incorporation by reference as therein provided.

[‡] As contemplated by Paragraph 8 of this Statement of Policy, this sentence is intended to be the subject of incorporation by reference as therein provided.

in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement)."

The accompanying Commentary is an integral part of this Statement of Policy.

Commentary

Paragraph 1 (Client Consent to Response)

In responding to any aspect of an auditor's inquiry letter, the lawyer must be guided by his ethical obligations as set forth in the Code of Professional Responsibility. Under Canon 4 of the Code of Professional Responsibility a lawyer is enjoined to preserve the client's confidences (defined as information protected by the attorney-client privilege under applicable law) and the client's secrets (defined as other information gained in the professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client). The observance of this ethical obligation, in the context of public policy, ". . . not only facilitates the full development of facts essential to proper representation of the client but also encourages laymen to seek early legal assistance." (Ethical Consideration 4-1).

The lawyer's ethical obligation therefore includes a much broader range of information than that protected by the attorney-client privilege. As stated in Ethical Consideration 4-4: "The attorney-client privilege is more limited than the ethical obligation of a lawyer to guard the confidences and secrets of his client. This ethical precept, unlike the evidentiary privilege, exists without regard to the nature or source of information or the fact that others share the knowledge."

In recognition of this ethical obligation, the lawyer should be careful to disclose fully to his client any confidence, secret or evaluation that is to be revealed to another, including the client's auditor, and to satisfy himself that the officer or agent of a corporate client consenting to the disclosure understands the legal consequences thereof and has authority to provide the required consent.

The law in the area of attorney-client privilege and the impact of statements made in letters to auditors upon that privilege has not yet been developed. Based upon cases treating the attorney-client privilege in other contexts, however, certain generalizations can be made with respect to the possible impact of statements in letters to auditors.

It is now generally accepted that a corporation may claim the attorney-client privilege. Whether the privilege extends beyond the control group of the corporation (a concept found in the existing decisional authority), and if so, how far, is yet unresolved.

If a client discloses to a third party a part of any privileged communication he has made to his attorney, there may have been a waiver as to the whole communication; further, it has been suggested that giving accountants *access* to privileged statements made to attorneys may waive any privilege as to those statements. Any disclosure of privileged communications relating to a particular subject matter may have the effect of waiving the privilege on other communications with respect to the same subject matter.

To the extent that the lawyer's knowledge of unasserted possible claims is obtained by means of confidential communications from the client, any disclosure thereof might constitute a waiver as fully as if the communication related to pending claims.

A further difficulty arises with respect to requests for evaluation of either pending or unasserted possible claims. It might be argued that any evaluation of a claim, to the extent based upon a confidential communication with the client, waives any privilege with respect to that claim.

Another danger inherent in a lawyer's placing a value on a claim, or estimating the likely result, is that such a statement might be treated as an admission or might be otherwise prejudicial to the client.

The Statement of Policy has been prepared in the expectation that judicial development of the law in the foregoing areas will be such that useful communication between lawyers and auditors in the manner envisaged in the Statement will not prove prejudicial to clients engaged in or threatened with adversary proceedings. If developments occur contrary to this expectation, appropriate review and revision of the Statement of Policy may be necessary.

Paragraph 2 (Limitation on Scope of Response)

In furnishing information to an auditor, the lawyer can properly limit himself to loss contingencies which he is handling on a substantive basis for the client in the form of legal consultation (advice and other attention to matters not in litigation by the lawyer in his professional capacity) or legal representation (counsel of record or other direct professional responsibility for a matter in litigation). Some auditors' inquiries go further and ask for information on matters of which the lawyer "has knowledge." Lawyers are concerned that such a broad request may be deemed to include information coming from a variety of sources including social contact and thirdparty contacts as well as professional engagement and that the lawyer might be criticized or subjected to liability if some of this information is forgotten at the time of the auditor's request.

It is also believed appropriate to recognize that the lawyer will not necessarily have been authorized to investigate, or have investigated, all legal problems of the client, even when on notice of some facts which might conceivably constitute a legal problem upon exploration and development. Thus, consideration in the form of preliminary or passing advice, or regarding an incomplete or hypothetical state of facts, or where the lawyer has not been requested to give studied attention to the matter in question, would not come within the concept of "substantive attention" and would therefore be excluded. Similarly excluded are matters which may have been mentioned by the client but which are not actually being handled by the lawyer. Paragraph 2 undertakes to deal with these concerns.

Paragraph 2 is also intended to recognize the principle that the appropriate lawyer to respond as to a particular loss contingency is the lawyer having charge of the matter for the client (e.g., the lawyer representing the client in a litigation matter and/or the lawyer having overall charge and supervision of the matter), and that the lawyer not having that kind of role with respect to the matter should not be expected to respond merely because of having become aware of its existence in a general or incidental way.

The internal procedures to be followed by a law firm or law department may vary based on factors such as the scope of the lawyer's engagement and the complexity and magnitude of the client's affairs. Such procedures could, but need not, include use of a docket system to record litigation, consultation with lawyers in the firm or department having principal responsibility for the client's affairs or other procedures which, in light of the cost to the client, are not disproportionate to the anticipated benefit to be derived. Although these procedures may not necessarily identify all matters relevant to the response, the

evolution and application of the lawyer's customary procedures should constitute a reasonable basis for the lawyer's response.

As the lawyer's response is limited to matters involving his professional engagement as counsel, such response should not include information concerning the client which the lawyer receives in another role. In particular, a lawyer who is also a director or officer of the client would not include information which he received as a director or officer unless the information was also received (or, absent the dual role, would in the normal course be received) in his capacity as legal counsel in the context of his professional engagement. Where the auditor's request for information is addressed to a law firm as a firm, the law firm may properly assume that its response is not expected to include any information which may have been communicated to the particular individual by reason of his serving in the capacity of director or officer of the client. The question of the individual's duty, in his role as a director or officer, is not here addressed.

Paragraph 3 (Response May Cover only Material Items in Certain Cases)

Paragraph 3 makes it clear that the lawyer may optionally limit his responses to those items which are individually or collectively material to the auditor's inquiry. If the lawyer takes responsibility for making a determination that a matter is not material for the purposes of his response to the audit inquiry, he should make it clear that his response is so limited. The auditor, in such circumstance, should properly be entitled to rely upon the lawyer's response as providing him with the necessary corroboration. It should be emphasized that the employment of inside general counsel by the client should not detract from the acceptability of his response since inside general counsel is as fully bound by the professional obligations and responsibilities contained in the Code of Professional Responsibility as outside counsel. If the audit inquiry sets forth a definition of materiality but the lawyer utilizes a different test of materiality, he should specifically so state. The lawyer may wish to reach an understanding with the auditor concerning the test of materiality to be used in his response, but he need not do so if he assumes responsibility for the criteria used in making materiality determinations. Any such understanding with the auditor should be referred to or set forth in the lawyer's response. In this connection, it is assumed that the test of materiality so agreed upon would not be so low in amount as to result in a disservice to the client and an unreasonable burden on counsel.

Paragraph 4 (Limited Responses)

The Statement of Policy is designed to recognize the obligation of the auditor to complete the procedures considered necessary to satisfy himself as to the fair presentation of the company's financial condition and results, in order to render a report which includes an opinion not qualified because of a limitation on the scope of the audit. In this connection, reference is made to SEC Accounting Series Release No. 90 [Financial Reporting Release No. 1, section 607.01(b)], in which it is stated:

> "A 'subject to' or 'except for' opinion paragraph in which these phrases refer to the scope of the audit, indicating that the accountant has not been able to satisfy himself on some significant element in the financial statements, is not acceptable in certificates filed with the Commission in connection with the public offering of securities. The 'subject to' qualification is appropriate when the reference is to a middle paragraph or to footnotes explaining the status of matters which cannot be resolved at statement date."

Paragraph 5 (Loss Contingencies)

Paragraph 5 of the Statement of Policy summarizes the categories of "loss contingencies" about which the lawyer may furnish information to the auditor. The term loss contingencies and the categories relate to concepts of accounting accrual and disclosure specified for the accounting profession in Statement of Financial Accounting Standards No. 5 ("FAS 5") issued by the Financial Accounting Standards Board in March, 1975.

5.1 Accounting Requirements

To understand the significance of the auditor's inquiry and the implications of any response the lawyer may give, the lawyer should be aware of the following accounting concepts and requirements set out in FAS 5:[||]

(a) A "loss contingency" is an existing condition, situation or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more events occur or fail to occur. Resolutions of the uncertainty may confirm the loss or impairment of an asset or the incurrence of a liability.

(Para. 1)

(b) When a "loss contingency" exists, the likelihood that a future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. There are three areas within that range, defined as follows:

(i) *Probable*—"The future event or events are likely to occur."

(ii) *Reasonably possible*—"The chance of the future event or events occurring is more than remote but less than likely."

(iii) *Remote*—"The chance of the future event or events occurring is slight."

(Para. 3)

(c) *Accrual* in a client's financial statements by a charge to income of the period will be required if *both* the following conditions are met:

(i) "Information available prior to issuance of the financial statements indicates that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be *probable* that one or more future events will occur confirming the fact of the loss." (emphasis added; footnote omitted)

(ii) "The amount of loss can be reasonably estimated."

(Para. 8)

(d) *If there is no accrual* of the loss contingency in the client's financial statements because one of the two conditions outlined in (*c*) above are not met, *disclosure* may be required as provided in the following:

> "If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, *disclosure* of

[||] Citations are to paragraph numbers of FAS 5.

the contingency *shall be made when there is at least a reasonable possibility* that a loss or an additional loss may have been incurred. *The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of* a loss contingency involving *an unasserted claim* or assessment *when there has been no manifestation by potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable*." (emphasis added; footnote omitted)

(Para. 10)

(e) The accounting requirements recognize or specify that (i) the opinions or views of counsel are not the sole source of evidential matter in making determinations about the accounting recognition or treatment to be given to litigation, and (ii) the fact that the lawyer is notable to express an opinion that the outcome will be favorable does not necessarily require an accrual of a loss. Paragraphs 36 and 37 of FAS 5 state as follows:

> "If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an enterprise's financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition in paragraph 8(*a*) is met. Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise's management as to how the enterprise intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement). The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss in paragraph 8(*a*) is met.
>
> "The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for accrual in paragraph 8(*a*) would be met if an unfavorable outcome is determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10 of this Statement."

(f) Paragraph 38 of FAS 5 focuses on certain examples concerning the determination by the enterprise whether an assertion of an unasserted possible claim may be considered probable:

> "With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise's patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8. If an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, accrual would not be appropriate, but disclosure would be required by paragraph 10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph 10."

For a more complete presentation of FAS 5, reference is made to Exhibit I, section 337B, in which are set forth excerpts selected by the AICPA as relevant to a Statement on Auditing Standards, issued by its Auditing Standards Executive Committee, captioned "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments."

5.2 Lawyer's Response

Concepts of probability inherent in the usage of terms like "probable" or "reasonably possible" or "remote" mean different things in different contexts. Generally, the outcome of, or the loss which may result from, litigation cannot be assessed in any way that is comparable to a statistically or empirically determined concept of "probability" that may be applicable when determining such matters as reserves for warranty obligations or accounts receivable or loan losses when there is a large number of transactions and a substantial body of known historical experience for the enterprise or comparable enterprises. While lawyers are accustomed to counseling clients during the progress of litigation as to the possible amount required for settlement purposes, the estimated risks of the proceedings at particular times and the possible application or establishment of points of law that may be relevant, such advice to the client is not possible at many stages of the litigation and may change dramatically depending upon the development of the proceedings. Lawyers do not generally quantify for clients the "odds" in numerical terms; if they do, the quantification is generally only undertaken in an effort to make meaningful, for limited purposes, a whole host of judgmental factors applicable at a particular time, without any intention to

depict "probability" in any statistical, scientific or empirically-grounded sense. Thus, for example, statements that litigation is being defended vigorously and that the client has meritorious defenses do not, and do not purport to, make a statement about the probability of outcome in any measurable sense.

Likewise, the "amount" of loss—that is, the total of costs and damages that ultimately might be assessed against a client—will, in most litigation, be a subject of wide possible variance at most stages; it is the rare case where the amount is precise and where the question is whether the client against which claim is made is liable either for all of it or none of it.

In light of the foregoing considerations, it must be concluded that, as a general rule, it should not be anticipated that meaningful quantifications of "probability" of outcome or amount of damages can be given by lawyers in assessing litigation. To provide content to the definitions set forth in Paragraph 5 of the Statement of Policy, this Commentary amplifies the meanings of the terms under discussion, as follows:

> "*probable*"—An unfavorable outcome is normally "probable" if, but only if, investigation, preparation (including development of the factual data and legal research) and progress of the matter have reached a stage where a judgment can be made, taking all relevant factors into account which may affect the outcome, that it is extremely doubtful that the client will prevail.
>
> "*remote*"—The prospect for an unfavorable outcome appears, at the time, to be slight; i.e., it is extremely doubtful that the client will not prevail. Normally, this would entail the ability to make an unqualified judgment, taking into account all relevant factors which may affect the outcome, that the client may confidently expect to prevail on a motion for summary judgment on all issues due to the clarity of the facts and the law.

In other words, for purposes of the lawyer's response to the request to advise auditors about litigation, an unfavorable outcome will be "probable" only if the chances of the client prevailing appear slight and of the claimant losing appear extremely doubtful; it will be "remote" when the client's chances of losing appear slight and of not winning appear extremely doubtful. It is, therefore, to be anticipated that, in most situations, an unfavorable outcome will be neither "probable" nor "remote" as defined in the Statement of Policy.

The discussion above about the very limited basis for furnishing judgments about the outcome of litigation applies with even more force to a judgment concerning whether or not the assertion of a claim not yet asserted is "probable." That judgment will infrequently be one within the professional competence of lawyers and therefore the lawyer should not undertake such assessment except where such judgment may become meaningful because of the presence of special circumstances, such as catastrophes, investigations and previous public disclosure as cited in Paragraph 5 of the Statement of Policy, or similar extrinsic evidence relevant to such assessment. Moreover, it is unlikely, absent relevant extrinsic evidence, that the client or anyone else will be in a position to make an informed judgment that assertion of a possible claim is "probable" as opposed to "reasonably possible" (in which event disclosure is not required). In light of the legitimate concern that the public interest would not be well served by resolving uncertainties in a way that invites the assertion of claims or otherwise causes unnecessary harm to the client and its stockholders, a decision to treat an unasserted claim as "probable" of assertion should be based only upon compelling judgment.

Consistent with these limitations believed appropriate for the lawyer, he should not represent to the auditor, nor should any inference from his response be drawn, that the unasserted possible claims identified by the client (as

contemplated by Paragraph 5(c) of the Statement of Policy) represent all such claims of which the lawyer may be aware or that he necessarily concurs in his client's determination of which unasserted possible claims warrant specification by the client; within proper limits, this determination is one which the client is entitled to make—and should make—and it would be inconsistent with his professional obligations for the lawyer to volunteer information arising from his confidential relationship with his client.

As indicated in Paragraph 5, the lawyer also may be asked to estimate the potential loss (or range) in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the lawyer would provide an estimate only if he believes that the probability of inaccuracy of the estimate of the range or amount is slight. What is meant here is that the estimate of amount of loss presents the same difficulty as assessment of outcome and that the same formulation of "probability" should be used with respect to the determination of estimated loss amounts as should be used with respect to estimating the outcome of the matter.

In special circumstances, with the proper consent of the client, the lawyer may be better able to provide the auditor with information concerning loss contingencies through conferences where there is opportunity for more detailed discussion and interchange. However, the principles set forth in the Statement of Policy and this Commentary are fully applicable to such conferences.

Subsumed throughout this discussion is the ongoing responsibility of the lawyer to assist his client, at the client's request, in complying with the requirements of FAS 5 to the extent such assistance falls within his professional competence. This will continue to involve, to the extent appropriate, privileged discussions with the client to provide a better basis on which the client can make accrual and disclosure determinations in respect of its financial statements.

In addition to the considerations discussed above with respect to the making of any judgment or estimate by the lawyer in his response to the auditor, including with respect to a matter specifically identified by the client, the lawyer should also bear in mind the risk that the furnishing of such a judgment or estimate to any one other than the client might constitute an admission or be otherwise prejudicial to the client's position in its defense against such litigation or claim (see Paragraph 1 of the Statement of Policy and of this Commentary).

Paragraph 6 (Lawyer's Professional Responsibility)

The client must satisfy whatever duties it has relative to timely disclosure, including appropriate disclosure concerning material loss contingencies, and, to the extent such matters are given substantive attention in the form of legal consultation, the lawyer, when his engagement is to advise his client concerning a disclosure obligation, has a responsibility to advise his client concerning its obligations in this regard. Although lawyers who normally confine themselves to a legal specialty such as tax, antitrust, patent or admiralty law, unlike lawyers consulted about SEC or general corporate matters, would not be expected to advise generally concerning the client's disclosure obligations in respect of a matter on which the lawyer is working, the legal specialist should counsel his client with respect to the client's obligations under FAS 5 to the extent contemplated herein. Without regard to legal specialty, the lawyer should be mindful of his professional responsibility to the client described in Paragraph 6 of the Statement of Policy concerning disclosure.

The lawyer's responsibilities with respect to his client's disclosure obligations have been a subject of considerable discussion and there may be, in due course, clarification and further guidance in this regard. In any event, where in the

lawyer's view it is clear that (i) the matter is of material importance and seriousness, and (ii) there can be no reasonable doubt that its non-disclosure in the client's financial statements would be a violation of law giving rise to material claims, rejection by the client of his advice to call the matter to the attention of the auditor would almost certainly require the lawyer's withdrawal from employment in accordance with the Code of Professional Responsibility. (See, e.g., Disciplinary Rule 7-102 (A)(3) and (7), and Disciplinary Rule 2-110 (B)(2).) Withdrawal under such circumstances is obviously undesirable and might present serious problems for the client. Accordingly, in the context of financial accounting and reporting for loss contingencies arising from unasserted claims, the standards for which are contained in FAS 5, clients should be urged to disclose to the auditor information concerning an unasserted possible claim or assessment (not otherwise specifically identified by the client) where in the course of the services performed for the client it has become clear to the lawyer that (i) the client has no reasonable basis to conclude that assertion of the claim is not probable (employing the concepts hereby enunciated) and (ii) given the probability of assertion, disclosure of the loss contingency in the client's financial statements is beyond reasonable dispute required.

Paragraph 7 (Limitation on Use of Response)

Some inquiry letters make specific reference to, and one might infer from others, an intention to quote verbatim or include the substance of the lawyer's reply in footnotes to the client's financial statements. Because the client's prospects in pending litigation may shift as a result of interim developments, and because the lawyer should have an opportunity, if quotation is to be made, to review the footnote in full, it would seem prudent to limit the use of the lawyer's reply letter. Paragraph 7 sets out such a limitation.

Paragraph 7 also recognizes that it may be in the client's interest to protect information contained in the lawyer's response to the auditor, if and to the extent possible, against unnecessary further disclosure or use beyond its intended purpose of informing the auditor. For example, the response may contain information which could prejudice efforts to negotiate a favorable settlement of a pending litigation described in the response. The requirement of consent to further disclosure, or of reasonable advance notice where disclosure may be required by court process or necessary in defense of the audit, is designed to give the lawyer an opportunity to consult with the client as to whether consent should be refused or limited or, in the case of legal process or the auditor's defense of the audit, as to whether steps can and should be taken to challenge the necessity of further disclosure or to seek protective measures in connection therewith. It is believed that the suggested standard of twenty days advance notice would normally be a minimum reasonable time for this purpose.

Paragraph 8 (General)

It is reasonable to assume that the Statement of Policy will receive wide distribution and will be readily available to the accounting profession. Specifically, the Statement of Policy has been reprinted as Exhibit II to the Statement on Auditing Standards, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," issued by the Auditing Standards Executive Committee of the American Institute of Certified Public Accountants. Accordingly, the mechanic for its incorporation by reference will facilitate lawyer-auditor communication. The incorporation is intended to include not only limitations, such as those provided by Paragraphs 2 and 7 of the Statement of Policy, but also the explanatory material set forth in this Commentary.

Annex A

[Illustrative forms of letters for full response by outside practitioner or law firm and inside general counsel to the auditor's inquiry letter. These illustrative forms, which are not part of the Statement of Policy, have been prepared by the Committee on Audit Inquiry Responses solely in order to assist those who may wish to have, for reference purposes, a form of response which incorporates the principles of the Statement of Policy and accompanying Commentary. Other forms of response letters will be appropriate depending on the circumstances.]

Illustrative form of letter for use by outside practitioner or law firm:

[Name and Address of Accounting Firm]

Re: [Name of Client] [and Subsidiaries]

Dear Sirs:

By letter date [*insert date of request*] Mr. [*insert name and title of officer signing request*] of [*insert name of client*] [(the "Company") or (together with its subsidiaries, the "Company")] has requested us to furnish you with certain information in connection with your examination of the accounts of the Company as at [*insert fiscal year-end*].

[Insert description of the scope of the lawyer's engagement; the following are sample descriptions:]

While this firm represents the Company on a regular basis, our engagement has been limited to specific matters as to which we were consulted by the Company.

[or]

We call your attention to the fact that this firm has during the past year represented the Company only in connection with certain [*Federal income tax matters*] [*litigation*] [*real estate transactions*] [*describe other specific matters, as appropriate*] and has not been engaged for any other purpose.

Subject to the foregoing and to the last paragraph of this letter, we advise you that since [*insert date of beginning of fiscal period under audit*] we have not been engaged to give substantive attention to, or represent the Company in connection with, [*material*][†] loss contingencies coming within the scope of clause (*a*) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]

[If the inquiry letter requests information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations:]

With respect to the matters specifically identified in the Company's letter and upon which comment has been specifically requested, as contemplated by clauses (*b*) or (*c*) of Paragraph 5 of the ABA Statement of Policy, we advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [as of the date of this letter] [as of [*insert date*], the date on which we commenced our internal review procedures for purposes of preparing this response], except as otherwise noted, and we disclaim any undertaking to advise you of changes which thereafter may be brought to our attention.

[†] ***Note:*** See Paragraph 3 of the Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

[Insert information with respect to outstanding bills for services and disbursements.]

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in its audit inquiry letter to us that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement]

Very truly yours,

Illustrative form of letter for use by inside general counsel:

[Name and Address of Accounting Firm]

Re: [Name of Company] [and Subsidiaries]

Dear Sirs:

As General Counsel[**] of [*insert name of client*] [(the "Company")] [(together with its subsidiaries, the "Company")], I advise you as follows in connection with your examination of the accounts of the Company as at [*insert fiscal year-end*].

I call your attention to the fact that as General Counsel[**] for the Company I have general supervision of the Company's legal affairs. [*If the general legal supervisory responsibilities of the person signing the letter are limited, set forth here a clear description of those legal matters over which such person exercises general supervision, indicating exceptions to such supervision and situations where primary reliance should be placed on other sources.*] In such capacity, I have reviewed litigation and claims threatened or asserted involving the Company and have consulted with outside legal counsel with respect thereto where I have deemed appropriate.

Subject to the foregoing and to the last paragraph of this letter, I advise you that since [*insert date of beginning of fiscal period under audit*] neither I, nor any of the lawyers over whom I exercise general legal supervision, have given substantive attention to, or represented the Company in connection with, [material][††] loss contingencies coming within the scope of clause (*a*) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]

[**] It may be appropriate in some cases for the response to be given by inside counsel other than inside general counsel in which event this letter should be appropriately modified.

[††] ***Note:*** See Paragraph 3 of the Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

[If information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations is to be supplied:]

With respect to matters which have been specifically identified as contemplated by clauses (*b*) or (*c*) of Paragraph 5 of the ABA Statement of Policy, I advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [as of the date of this letter] as of [*insert date*], the date on which we commenced our internal review procedures for purposes of preparing this response], except as otherwise noted, and I disclaim any undertaking to advise you of changes which thereafter may be brought to my attention or to the attention of the lawyers over whom I exercise general legal supervision.

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy, this will confirm as correct the Company's understanding that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, I have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, I, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement.]

Very truly yours,

AU Section 9337

Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337

1. Specifying Relevant Date in an Audit Inquiry Letter

.01 *Question*—Should the auditor request the client to specify, in his audit inquiry letter to a lawyer prepared in accordance with section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, the date by which the lawyer's response should be sent to the auditor. Also, should the letter request the lawyer to specify in his response the latest date covered by his review (the "effective date")?

.02 *Interpretation*—Yes. It should be recognized that, to adequately respond to an audit inquiry letter, lawyers will ordinarily employ some internal review procedures which will be facilitated by specifying the earliest acceptable effective date of the response and the latest date by which it should be sent to the auditor. Ordinarily, a two-week period should be allowed between the specified effective date of the lawyer's response and the latest date by which the response should be sent to the auditor. Clearly stating the relevant dates in the letter and specifying these dates to the lawyer in a timely manner will allow the responding lawyer an adequate amount of time to complete his review procedures and assist the auditor in coordinating the timing of the completion of his field work with the latest date covered by the lawyer's review.

.03 Further, the lawyer should be requested to specify the effective date of his response. If the lawyer's response does not specify an effective date, the auditor can assume that the date of the lawyer's response is the effective date.

[Issue Date: March, 1977.]

2. Relationship Between Date of Lawyer's Response and Auditor's Report

.04 *[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]*

Question—The illustrative form of audit inquiry letter included in the Appendix [section 337A] to section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, requests a response as to matters that existed at the balance sheet date and during the period from that date to the date of the response. What is the relationship between the effective date of the lawyer's response and the date of the auditor's report?

.05 *[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]*

Interpretation—Section 560.10 through .12 indicates that the auditor is concerned with events, which may require adjustment to, or disclosure in, the financial statements, occurring through the date of his or her report. Therefore, the latest date of the period covered by the lawyer's response (the "effective date") should be as close to the date of the auditor's report as is practicable in the circumstances. Consequently, specifying the effective date of the lawyer's

response to reasonably approximate the expected date of the auditor's report will in most instances obviate the need for an updated response from the lawyer.

[Issue Date: March, 1977; Revised October, 2007.]

3. Form of Audit Inquiry Letter When Client Represents That No Unasserted Claims and Assessments Exist

.06 *Question*—The illustrative audit inquiry letter included in the Appendix [section 337A] to section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, assumes that the client specifies certain unasserted claims and assessments. However, in some cases, clients have stated that there are no such claims or assessments (to be specified to the lawyer for comment) that are probable of assertion and that, if asserted, would have a reasonable possibility of an unfavorable outcome. What appropriate revision to the wording of the letter can be used in such situations?

.07 *Interpretation*—Wording that could be used in an audit inquiry letter, instead of the heading and first paragraph in the section relating to unasserted claims and assessments included in the Appendix [section 337A] to section 337, when the client believes that there are no unasserted claims or assessments (to be specified to the lawyer for comment) that are probable of assertion and that, if asserted, would have a reasonable possibility of an unfavorable outcome as specified by FASB Statement No. 5, *Accounting for Contingencies* [AC section C59], is as follows:

> *Unasserted claims and assessments*—We have represented to our auditors that there are no unasserted possible claims that you have advised us are probable of assertion and must be disclosed, in accordance with Statement of Financial Accounting Standards No. 5. (The second paragraph in the section relating to unasserted claims and assessments would not be altered.)

[Issue Date: March, 1977.]

4. Documents Subject to Lawyer-Client Privilege

.08 *Question*—Section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, paragraph .05*c*, states: "Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers." Would this include a review of documents at the client's location considered by the lawyer and the client to be subject to the lawyer-client privilege?

.09 *Interpretation*—No. Although ordinarily an auditor would consider the inability to review information that could have a significant bearing on his audit as a scope restriction, in recognition of the public interest in protecting the confidentiality of lawyer-client communications (see section 337.13), section 337.05*c* is not intended to require an auditor to examine documents that the client identifies as subject to the lawyer-client privilege. In the event of questions concerning the applicability of this privilege, the auditor may request confirmation from the client's counsel that the information is subject to that privilege and that the information was considered by the lawyer in responding to the audit inquiry letter or, if the matters are being handled by another lawyer, an identification of such lawyer for the purpose of sending him an audit inquiry letter.

[Issue Date: March, 1977.]

5. Alternative Wording of the Illustrative Audit Inquiry Letter to a Client's Lawyer

.10 *Question*—The Appendix [section 337A] of section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, provides an illustrative audit inquiry letter to legal counsel. That inquiry letter is based on the assumptions that (1) management of the company has prepared and furnished to the auditor and has set forth in the audit inquiry letter a description and evaluation of pending or threatened litigation, claims, and assessments and (2) management has identified and specified for comment in the audit inquiry letter unasserted claims or assessments that are probable of assertion and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome. In many engagements, circumstances may render certain portions of the illustrative letter inappropriate. For instance, many clients ask their lawyers to prepare the list that describes and evaluates pending or threatened litigation, claims, and assessments rather than have management furnish such information. How can the wording of the inquiry letter be modified to recognize circumstances that differ from those assumed in the illustrative letter and to be more specific regarding the timing of the lawyer's response?

.11 *Interpretation*—Section 337.09, outlines the matters that should be covered in a letter of audit inquiry. Although section 337 provides an illustrative audit inquiry letter to legal counsel, it should be modified, if necessary, to fit the circumstances. The modified illustrative audit inquiry letter that follows is based on a typical situation: management requests the lawyer to prepare the list that describes and evaluates pending or threatened litigation, claims, and assessments, and also represents that there are no unasserted claims or assessments that are probable of assertion and that, if asserted, would have a reasonable possibility of an unfavorable outcome as specified by FASB Statement No. 5, *Accounting for Contingencies* [AC section C59]. It also includes a separate response section with language that clarifies the auditor's expectations regarding the timing of the lawyer's response.

"In connection with an audit of our financial statements as of (balance-sheet date) and for the (period) then ended, please furnish our auditors, (name and address of auditors), with the information requested below concerning certain contingencies involving matters with respect to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation." [When a materiality limit has been established based on an understanding between management and the auditor, the following sentence should be added: This request is limited to contingencies amounting to (amount) individually or items involving lesser amounts that exceed (amount) in the aggregate.]

.12 Pending or Threatened Litigation, Claims, and Assessments

"Regarding pending or threatened litigation, claims, and assessments, please include in your response: (1) the nature of each matter, (2) the progress of each matter to date, (3) how the Company is responding or intends to respond (for example, to contest the case vigorously or seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss."

.13 Unasserted Claims and Assessments

"We have represented to our auditors that there are no unasserted possible claims or assessments that you have advised us are probable of assertion and

must be disclosed in accordance with FASB Statement No. 5 [AC section C59].[1] We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of FASB Statement No. 5 [AC section C59]. Please specifically confirm to our auditors that our understanding is correct."

.14 Response

"Your response should include matters that existed as of (balance-sheet date) and during the period from that date to the effective date of your response."

"Please specifically identify the nature of and reasons for any limitations on your response."

"Our auditors expect to have the audit completed about (expected completion date). They would appreciate receiving your reply by that date with a specified effective date no earlier than (ordinarily two weeks before expected completion date)."[2]

[Issue Date: June 1983.]

6. Client Has Not Consulted a Lawyer

.15 *Question*—Section 337.06 requires an auditor to request that the client's management send a letter of inquiry to those lawyers with whom management has consulted concerning litigation, claims, or assessments. In some instances, management may not have consulted a lawyer. In such circumstances, what should the auditor do to obtain sufficient, competent evidential matter regarding litigation, claims, and assessments?

.16 *Interpretation*—Section 337 is expressly limited to inquiry of lawyers with whom management has consulted. If the client has not consulted a lawyer, the auditor normally would rely on the review of internally available information as outlined in section 337.05 and .07, and the written representation of management regarding litigation, claims, and assessments as required by section 333, *Management Representations*, paragraph .06*m* and *n*. In those circumstances, the representation regarding litigation, claims, and assessments might be worded as follows:

"We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with FASB Statement No. 5 [AC section C59], and we have not consulted a lawyer concerning litigation, claims, or assessments."

.17 If information comes to the auditor's attention that may indicate potentially material litigation, claims, and assessments, the auditor should discuss with the client its possible need to consult legal counsel so that the client may

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[1] A parenthetical statement such as "(excerpts of which can be found in the ABA's *Auditor's Letter Handbook*)" might be added here if the auditor believes that it would be helpful to the lawyer's understanding of the requirements of FASB Statement No. 5 [AC section C59]. *The Auditor's Letter Handbook* contains, among other things, a copy of section 337, the ABA's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* [section 337C], and excerpts from FASB Statement No. 5 [AC section C59].

[2] Two auditing interpretations (see sections 9337.01-.05) address relevant dates in an audit inquiry letter and the relationship between the date of the lawyer's response and the audit report date.

evaluate its responsibility under FASB Statement No. 5 [AC section C59] to accrue or disclose loss contingencies. Depending on the severity of the matter, refusal by the client to consult legal counsel in those circumstances may result in a scope limitation, and the auditor should consider the effect of such a limitation on his audit report.

[Issue Date: June 1983.]

7. Assessment of a Lawyer's Evaluation of the Outcome of Litigation

.18 *Question*—Section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, paragraph .09*d*(2), states that a letter of audit inquiry should include a request for the lawyer's evaluation of the likelihood of an unfavorable outcome of pending or threatened litigation, claims, and assessments to which he has devoted substantive attention. However, written responses from lawyers vary considerably and may contain evaluation wording that is vague or ambiguous and, thus, of limited use to the auditor. What constitutes a clear response and what should the auditor do if he considers the response unclear?

.19 *Interpretation*—The American Bar Association's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* (ABA Statement) is reprinted as Exhibit II [section 337C] to section 337. While Paragraph 5 of the ABA Statement [section 337C] states that the lawyer "may in appropriate circumstances communicate to the auditor his view that an unfavorable outcome is 'probable' or 'remote'," he is not required to use those terms in communicating his evaluation to the auditor. The auditor may find other wording sufficiently clear as long as the terms can be used to classify the outcome of the uncertainty under one of the three probability classifications established in FASB Statement No. 5, *Accounting for Contingencies* [AC section C59].[3]

.20 Some examples of evaluations concerning litigation that may be considered to provide sufficient clarity that the likelihood of an unfavorable outcome is "remote" even though they do not use that term are:

- "We are of the opinion that this action will not result in any liability to the company."
- "It is our opinion that the possible liability to the company in this proceeding is nominal in amount."
- "We believe the company will be able to defend this action successfully."
- "We believe that the plaintiff's case against the company is without merit."
- "Based on the facts known to us, after a full investigation, it is our opinion that no liability will be established against the company in these suits."

.21 Absent any contradictory information obtained by the auditor either in other parts of the lawyer's letter or otherwise, the auditor need not obtain further clarification of evaluations such as the foregoing.

.22 Because of inherent uncertainties described in section 337.14 and in the ABA Policy Statement [section 337C], an evaluation furnished by the lawyer

[3] FASB Statement No. 5 [AC section C59] uses the terms "probable," "reasonably possible," and "remote" to describe different degrees of likelihood that future events will confirm a loss or an impairment of an asset or incurrence of a liability, and the accounting standards for accrual and disclosure are based on those terms.

may indicate significant uncertainties or stipulations as to whether the client will prevail. The following are examples of lawyers' evaluations that are unclear as to the likelihood of an unfavorable outcome:

- "This action involves unique characteristics wherein authoritative legal precedents do not seem to exist. We believe that the plaintiff will have serious problems establishing the company's liability under the act; nevertheless, if the plaintiff is successful, the award may be substantial."
- "It is our opinion that the company will be able to assert meritorious defenses to this action." (The term "meritorious defenses" indicates that the company's defenses will not be summarily dismissed by the court; it does not necessarily indicate counsel's opinion that the company will prevail.)
- "We believe the action can be settled for less than the damages claimed."
- "We are unable to express an opinion as to the merits of the litigation at this time. The company believes there is absolutely no merit to the litigation." (If client's counsel, with the benefit of all relevant information, is unable to conclude that the likelihood of an unfavorable outcome is "remote," it is unlikely that management would be able to form a judgment to that effect.)
- "In our opinion, the company has a substantial chance of prevailing in this action." (A "substantial chance," a "reasonable opportunity," and similar terms indicate more uncertainty than an opinion that the company will prevail.)

.23 If the auditor is uncertain as to the meaning of the lawyer's evaluation, he should request clarification either in a follow-up letter or a conference with the lawyer and client, appropriately documented. If the lawyer is still unable to give an unequivocal evaluation of the likelihood of an unfavorable outcome in writing or orally, the auditor should look to the guidance in section 508.45 through .49 to determine the effect, if any, of the lawyer's response on the auditor's report.

[Issue Date: June, 1983; Revised: February, 1997.]

8. Use of the Client's Inside Counsel in the Evaluation of Litigation, Claims, and Assessments

.24 *Question*—Section 337.06 requires an auditor to request that the client's management send a letter of inquiry to those lawyers with whom management has consulted concerning litigation, claims, and assessments. Sometimes, the client's inside general counsel or legal department (hereinafter referred to as "inside counsel") is handling litigation, claims, and assessments either exclusive of or in conjunction with outside lawyers. In such circumstances, when does inside counsel's response constitute sufficient, competent evidential matter regarding litigation, claims, and assessments?

.25 *Interpretation*—Section 337.08 states that "Evidential matter obtained from the client's inside general counsel or legal department may provide the auditor with the necessary corroboration." Inside counsel can range from one lawyer to a large staff, with responsibilities ranging from specific internal matters to a comprehensive coverage of all of the client's legal needs, including litigation with outside parties. Because both inside counsel and outside lawyers are bound by the ABA's Code of Professional Responsibilities, there is no difference

in their professional obligations and responsibilities. In some circumstances, outside lawyers, if used at all, may be used only for limited purposes, such as data accumulation or account collection activity. In such circumstances, inside counsel has the primary responsibility for corporate legal matters and is in the best position to know and precisely describe the status of all litigation, claims, and assessments or to corroborate information furnished by management.

.26 Audit inquiry letters should be sent to those lawyers, which may be either inside counsel or outside lawyers, who have the primary responsibility for, and knowledge about, particular litigation, claims, and assessments. If inside counsel in handling litigation, claims, and assessments exclusively, their evaluation and response ordinarily would be considered adequate. Similarly, if both inside counsel and outside lawyers have been involved in the matters, but inside counsel ha s assumed the primary responsibility for the matters, inside counsel's evaluation may well be considered adequate.[4] However, there may be circumstances when litigation, claims, or assessments involving substantial overall participation by outside lawyers are of such significance to the financial statements that the auditor should consider obtaining the outside lawyers' response that they have not formulated a substantive conclusion that differs in any material respect from inside counsel's evaluation, even though inside counsel may have primary responsibility.

.27 If both inside counsel and outside lawyers have devoted substantive attention to a legal matter, but their evaluations of the possible outcome differ, the auditor should discuss the differences with the parties involved. Failure to reach agreement between the lawyers may require the auditor to consider appropriate modification of his audit report.

[Issue Date: June 1983.]

9. Use of Explanatory Language About the Attorney-Client Privilege or the Attorney Work-Product Privilege

.28 *Question*—In some cases, in order to emphasize the preservation of the attorney-client privilege or the attorney work-product privilege, some clients have included the following or substantially similar language in the audit inquiry letter to legal counsel:

> We do not intend that either our request to you to provide information to our auditor or your response to our auditor should be construed in any way to constitute a waiver of the attorney-client privilege or the attorney work-product privilege.

For the same reason, some lawyers have included the following or substantially similar language in their response letters to auditors:

> The Company [OR OTHER DEFINED TERM] has advised us that, by making the request set forth in its letter to us, the Company [OR OTHER DEFINED TERM] does not intend to waive the attorney-client privilege with respect to any information which the Company [OR OTHER DEFINED TERM] has furnished to us. Moreover, please be advised that our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege with respect to any of our files involving the Company [OR OTHER DEFINED TERM].

Does the explanatory language about the attorney-client privilege or the attorney work-product privilege result in a limitation on the scope of the audit?

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[4] This does not alter the caveat in section 337.08 that "evidential matter obtained from inside counsel is not a substitute for information outside counsel refuses to furnish."

.29 *Answer*—No. According to the *Report by the American Bar Association's Subcommittee on Audit Inquiry Responses*, explanatory language similar to the foregoing in the letters of the client or the lawyer is not a limitation on the scope of the lawyer's response. The report states that such language simply makes explicit what has always been implicit, namely, the language states clearly that neither the client nor the lawyer intended a waiver. The report further states that non-inclusion of either or both of the foregoing statements by the client or the lawyer in their respective letters at any time in the past or the future would not constitute an expression of intent to waive the privileges. The *Report by the American Bar Association's Subcommittee on Audit Inquiry Responses* is reprinted in paragraph .30.

.30 Report of the Subcommittee on Audit Inquiry Responses*

Because of a recent court case and other judicial decisions involving lawyers' responses to auditors' requests for information, an area of uncertainty or concern has been brought to the Subcommittee's attention and is the subject of the following comment:

This Committee's report does not modify the ABA Statement of Policy, nor does it constitute an interpretation thereof. The Preamble to the ABA Statement of Policy states as follows:

> Both the Code of Professional Responsibility and the cases applying the evidentiary privilege recognize that the privilege against disclosure can be knowingly and voluntarily waived by the client. It is equally clear that disclosure to a third party may result in loss of the "confidentiality" essential to maintain the privilege. Disclosure to a third party of the lawyer-client communication on a particular subject may also destroy the privilege as to other communications on that subject. Thus, the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and client may significantly impair the client's ability in other contexts to maintain the confidentiality of such communications.
>
> Under the circumstances a policy of audit procedure which requires clients to give consent and authorize lawyers to respond to general inquiries and disclose information to auditors concerning matters which have been communicated in confidence is essentially destructive of free and open communication and early consultation between lawyer and client. The institution of such a policy would inevitably discourage management from discussing potential legal problems with counsel for fear that such discussion might become public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.
>
> It is also recognized that our legal, political, and economic systems depend to an important extent on public confidence in published financial statements. To meet this need the accounting profession must adopt and adhere to standards and procedures that will command confidence in the auditing process. It is not, however, believed necessary, or sound public policy, to intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence. On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between lawyer and client, thereby strengthening corporate management's confidence in counsel and to act in accordance with counsel's advice.

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* "Excerpted from 'Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information,' *The Business Lawyer*, vol. 31, no. 3, April 1976, copyright 1976 American Bar Association, reprinted by permission of the American Bar Association."

Paragraph (1) of the ABA Statement of Policy provides as follows:

> **(1)** *Client Consent to Response.* The lawyer may properly respond to the auditor's requests for information concerning loss contingencies (the term and concept established by Statement of Financial Accounting Standards No. 5, promulgated by the Financial Accounting Standards Board in March 1975 and discussed in Paragraph 5.1 of the accompanying commentary), to the extent hereinafter set forth, subject to the following:
>
> ***(a)*** Assuming that the client's initial letter requesting the lawyer to provide information to the auditor is signed by an agent of the client having apparent authority to make such a request, the lawyer may provide to the auditor information requested, without further consent, unless such information discloses a confidence or a secret or requires an evaluation of a claim.
>
> ***(b)*** In the normal case, the initial request letter does not provide the necessary consent to the disclosure of a confidence or secret or to the evaluation of a claim since that consent may only be given after full disclosure to the client of the legal consequences of such action.
>
> ***(c)*** Lawyers should bear in mind, in evaluating claims, that an adverse party may assert that any evaluation of potential liability is an admission.
>
> ***(d)*** In securing the client's consent to the disclosure of confidences or secrets, or the evaluation of claims, the lawyer may wish to have a draft of his letter reviewed and approved by the client before releasing it to the auditor; in such cases, additional explanation would in all probability be necessary so that the legal consequences of the consent are fully disclosed to the client.

In order to preserve explicitly the evidentiary privileges, some lawyers have suggested that clients include language in the following or substantially similar form:

> We do not intend that either our request to you to provide information to our auditor or your response to our auditor should be construed in any way to constitute a waiver of the attorney-client privilege or the attorney work-product privilege.

If client's request letter does not contain language similar to that in the preceding paragraph, the lawyer's statement that the client has so advised him or her may be based upon the fact that the client has in fact so advised the lawyer, in writing or orally, in other communications or in discussions.

For the same reason, the response letter from some lawyers also includes language in the following or substantially similar form:

> The Company [OR OTHER DEFINED TERM] has advised us that, by making the request set forth in its letter to us, the Company [OR OTHER DEFINED TERM] does not intend to waive the attorney-client privilege with respect to any information which the Company [OR OTHER DEFINED TERM] has furnished to us. Moreover, please be advised that our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege with respect to any of our files involving the Company [OR OTHER DEFINED TERM].

We believe that language similar to the foregoing in letters of the client or the lawyer simply makes explicit what has always been implicit, namely, it expressly states clearly that neither the client nor the lawyer intended a waiver. It follows that non-inclusion of either or both of the foregoing statements by the client or the lawyer in their respective letters at any time in the past or the future would not constitute an expression of intent to waive the privileges.

On the other hand, the inclusion of such language does not necessarily assure the client that, depending on the facts and circumstances, a waiver may not be found by a court of law to have occurred.

We do not believe that the foregoing types of inclusions cause a negative impact upon the public policy considerations described in the Preamble to the ABA Statement of Policy nor do they intrude upon the arrangements between the legal profession and the accounting profession contemplated by the ABA Statement of Policy. Moreover, we do not believe that such language interferes in any way with the standards and procedures of the accounting profession in the auditing process nor should it be construed as a limitation upon the lawyer's reply to the auditors. We have been informed that the Auditing Standards Board of the AICPA has adopted an interpretation of SAS 12 recognizing the propriety of these statements.

Lawyers, in any case, should be encouraged to have their draft letters to auditors reviewed and approved by the client before releasing them to the auditors and may wish to explain to the client the legal consequences of the client's consent to lawyer's response as contemplated by subparagraph 1(*d*) of the Statement of Policy.

December 1989

[Issue Date: February, 1990.]

10. Use of Explanatory Language Concerning Unasserted Possible Claims or Assessments in Lawyers' Responses to Audit Inquiry Letters

.31 *Question*—In order to emphasize the preservation of the attorney-client privilege with respect to unasserted possible claims or assessments, some lawyers include the following or substantially similar language in their responses to audit inquiry letters:

> "Please be advised that pursuant to clauses (*b*) and (*c*) of Paragraph 5 of the ABA Statement of Policy [American Bar Association's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*] and related Commentary referred to in the last paragraph of this letter, it would be inappropriate for this firm to respond to a general inquiry relating to the existence of unasserted possible claims or assessments involving the Company. We can only furnish information concerning those unasserted possible claims or assessments upon which the Company has specifically requested in writing that we comment. We also cannot comment upon the adequacy of the Company's listing, if any, of unasserted possible claims or assessments or its assertions concerning the advice, if any, about the need to disclose same."

Does the inclusion of this or similar language result in a limitation on the scope of the audit?

.32 *Interpretation*—No. Additional language similar to the foregoing in a letter of a lawyer is not a limitation on the scope of the audit. However, the ABA Statement of Policy [section 337C] and the understanding between the legal and

accounting professions assumes that the lawyer, under certain circumstances, will advise and consult with the client concerning the client's obligation to make financial statement disclosure with respect to unasserted possible claims or assessments.[5] Confirmation of this understanding should be included in the lawyer's response.

[Issue Date: January, 1997.]

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[5] See Paragraph 6 of the ABA Statement of Policy [section 337C] and its Commentary [section 337C]. In addition, Annex A to the ABA Statement of Policy [section 337C] contains the following illustrative language in the lawyers' response letter to the auditors: "Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in its audit inquiry letter to us that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of FASB Statement No. 5, *Accounting for Contingencies* [AC section C59]."

AU Section 339

Audit Documentation

[Superseded by PCAOB Auditing Standard No. 3, Audit Documentation*, effective for audits of fiscal years ending on or after November 15, 2004, and effective for other engagements conducted pursuant to the standards of the PCAOB, including reviews of interim information, in the first quarter ending after the first audit covered by this standard. See PCAOB Release No. 2004-006.]*

AU Section 9339

Audit Documentation: Auditing Interpretations of Section 339

[Superseded by PCAOB Auditing Standard No. 3, Audit Documentation*, effective for audits of fiscal years ending on or after November 15, 2004, and effective for other engagements conducted pursuant to the standards of the PCAOB, including reviews of interim information, in the first quarter ending after the first audit covered by this standard. See PCAOB Release No. 2004-006.]*

AU Section 341

The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern

(Supersedes section 340)

Source: SAS No. 59; SAS No. 64; SAS No. 77; SAS No. 96; Auditing Standard No. 5; Auditing Standard Nos. 8–15; Auditing Standard No. 16.

See section 9341 for interpretations of this section.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

.01 This section provides guidance to the auditor in conducting an audit of financial statements in accordance with generally accepted auditing standards with respect to evaluating whether there is substantial doubt about the entity's ability to continue as a going concern.[1,2] Continuation of an entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. Ordinarily, information that significantly contradicts the going concern assumption relates to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions.

The Auditor's Responsibility

.02 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited (hereinafter referred to as a *reasonable period of time*). The auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited, as described in Auditing Standard No. 15, *Audit Evidence*.

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[1] This section does not apply to an audit of financial statements based on the assumption of liquidation (for example, when [*a*] an entity is in the process of liquidation, [*b*] the owners have decided to commence dissolution or liquidation, or [*c*] legal proceedings, including bankruptcy, have reached a point at which dissolution or liquidation is probable). See Auditing Interpretation, "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting" (section 9508.33-.38).

[2] The guidance provided in this section applies to audits of financial statements prepared either in accordance with generally accepted accounting principles or in accordance with a comprehensive basis of accounting other than generally accepted accounting principles. References in this section to generally accepted accounting principles are intended to include a comprehensive basis of accounting other than generally accepted accounting principles (excluding liquidation basis).

.03 The auditor should evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in the following manner:

a. The auditor considers whether the results of his procedures performed in planning, gathering evidential matter relative to the various audit objectives, and completing the audit identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. It may be necessary to obtain additional information about such conditions and events, as well as the appropriate evidential matter to support information that mitigates the auditor's doubt.

b. If the auditor believes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, he should (1) obtain information about management's plans that are intended to mitigate the effect of such conditions or events, and (2) assess the likelihood that such plans can be effectively implemented.

c. After the auditor has evaluated management's plans, he concludes whether he has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If the auditor concludes there is substantial doubt, he should (1) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (2) include an explanatory paragraph (following the opinion paragraph) in his audit report to reflect his conclusion. If the auditor concludes that substantial doubt does not exist, he should consider the need for disclosure.

.04 The auditor is not responsible for predicting future conditions or events. The fact that the entity may cease to exist as a going concern subsequent to receiving a report from the auditor that does not refer to substantial doubt, even within one year following the date of the financial statements, does not, in itself, indicate inadequate performance by the auditor. Accordingly, the absence of reference to substantial doubt in an auditor's report should not be viewed as providing assurance as to an entity's ability to continue as a going concern.

Audit Procedures

.05 It is not necessary to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose. The following are examples of procedures that may identify such conditions and events:

- Analytical procedures
- Review of subsequent events
- Review of compliance with the terms of debt and loan agreements
- Reading of minutes of meetings of stockholders, board of directors, and important committees of the board

- Inquiry of an entity's legal counsel about litigation, claims, and assessments
- Confirmation with related and third parties of the details of arrangements to provide or maintain financial support

Consideration of Conditions and Events

.06 In performing audit procedures such as those presented in paragraph .05, the auditor may identify information about certain conditions or events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The significance of such conditions and events will depend on the circumstances, and some may have significance only when viewed in conjunction with others. The following are examples of such conditions and events:

- *Negative trends*—for example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, adverse key financial ratios
- *Other indications of possible financial difficulties*—for example, default on loan or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, restructuring of debt, noncompliance with statutory capital requirements, need to seek new sources or methods of financing or to dispose of substantial assets
- *Internal matters*—for example, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, need to significantly revise operations
- *External matters that have occurred*—for example, legal proceedings, legislation, or similar matters that might jeopardize an entity's ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; uninsured or underinsured catastrophe such as a drought, earthquake, or flood

Consideration of Management's Plans

.07 If, after considering the identified conditions and events in the aggregate, the auditor believes there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, he should consider management's plans for dealing with the adverse effects of the conditions and events. The auditor should obtain information about the plans and consider whether it is likely the adverse effects will be mitigated for a reasonable period of time and that such plans can be effectively implemented. The auditor's considerations relating to management plans may include the following:

- Plans to dispose of assets
  - — Restrictions on disposal of assets, such as covenants limiting such transactions in loan or similar agreements or encumbrances against assets
  - — Apparent marketability of assets that management plans to sell
  - — Possible direct or indirect effects of disposal of assets

- Plans to borrow money or restructure debt
  - — Availability of debt financing, including existing or committed credit arrangements, such as lines of credit or arrangements for factoring receivables or sale-leaseback of assets
  - — Existing or committed arrangements to restructure or subordinate debt or to guarantee loans to the entity
  - — Possible effects on management's borrowing plans of existing restrictions on additional borrowing or the sufficiency of available collateral
- Plans to reduce or delay expenditures
  - — Apparent feasibility of plans to reduce overhead or administrative expenditures, to postpone maintenance or research and development projects, or to lease rather than purchase assets
  - — Possible direct or indirect effects of reduced or delayed expenditures
- Plans to increase ownership equity
  - — Apparent feasibility of plans to increase ownership equity, including existing or committed arrangements to raise additional capital
  - — Existing or committed arrangements to reduce current dividend requirements or to accelerate cash distributions from affiliates or other investors

.08 When evaluating management's plans, the auditor should identify those elements that are particularly significant to overcoming the adverse effects of the conditions and events and should plan and perform auditing procedures to obtain evidential matter about them. For example, the auditor should consider the adequacy of support regarding the ability to obtain additional financing or the planned disposal of assets.

.09 When prospective financial information is particularly significant to management's plans, the auditor should request management to provide that information and should consider the adequacy of support for significant assumptions underlying that information. The auditor should give particular attention to assumptions that are—

- Material to the prospective financial information.
- Especially sensitive or susceptible to change.
- Inconsistent with historical trends.

The auditor's consideration should be based on knowledge of the entity, its business, and its management and should include (*a*) reading of the prospective financial information and the underlying assumptions and (*b*) comparing prospective financial information in prior periods with actual results and comparing prospective information for the current period with results achieved to date. If the auditor becomes aware of factors, the effects of which are not reflected in such prospective financial information, he should discuss those factors with management and, if necessary, request revision of the prospective financial information.

Consideration of Financial Statement Effects

.10 When, after considering management's plans, the auditor concludes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, the auditor should consider the possible effects on the financial statements and the adequacy of the related disclosure. Some of the information that might be disclosed includes—

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- The possible effects of such conditions and events.
- Management's evaluation of the significance of those conditions and events and any mitigating factors.
- Possible discontinuance of operations.
- Management's plans (including relevant prospective financial information).[3]
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

.11 When, primarily because of the auditor's consideration of management's plans, he concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time is alleviated, he should consider the need for disclosure of the principal conditions and events that initially caused him to believe there was substantial doubt. The auditor's consideration of disclosure should include the possible effects of such conditions and events, and any mitigating factors, including management's plans.

Consideration of the Effects on the Auditor's Report

.12 If, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph (following the opinion paragraph) to reflect that conclusion.[4] The auditor's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern" [or similar wording that includes the terms substantial doubt *and* going concern] as illustrated in paragraph .13. [As amended, effective for reports issued after December 31, 1990, by Statement on Auditing Standards No. 64.]

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[3] It is not intended that such prospective financial information constitute prospective financial statements meeting the minimum presentation guidelines set forth in AT section 301, *Financial Forecasts and Projections*, nor that the inclusion of such information require any consideration beyond that normally required by generally accepted auditing standards. [Footnote revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

[4] The inclusion of an explanatory paragraph (following the opinion paragraph) in the auditor's report contemplated by this section should serve adequately to inform the users of the financial statements. Nothing in this section, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner (see paragraph .10), and the auditor's report should give all the substantive reasons for his disclaimer of opinion (see section 508, *Reports on Audited Financial Statements*).

.13 An example follows of an explanatory paragraph (following the opinion paragraph) in the auditor's report describing an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time.[5]

> The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[As amended, effective for reports issued after December 31, 1990, by Statement on Auditing Standards No. 64.]

.14 If the auditor concludes that the entity's disclosures with respect to the entity's ability to continue as a going concern for a reasonable period of time are inadequate, a departure from generally accepted accounting principles exists. This may result in either a qualified (except for) or an adverse opinion. Reporting guidance for such situations is provided in section 508, *Reports on Audited Financial Statements*.

.15 Substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time that arose in the current period does not imply that a basis for such doubt existed in the prior period and, therefore, should not affect the auditor's report on the financial statements of the prior period that are presented on a comparative basis. When financial statements of one or more prior periods are presented on a comparative basis with financial statements of the current period, reporting guidance is provided in section 508.

.16 If substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time existed at the date of prior period financial statements that are presented on a comparative basis, and that doubt has been removed in the current period, the explanatory paragraph included in the auditor's report (following the opinion paragraph) on the financial statements of the prior period should not be repeated.

Documentation

.17 As stated in paragraph .03 of this section, the auditor considers whether the results of the auditing procedures performed in planning, gathering evidential matter relative to the various audit objectives, and completing the audit identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If, after considering the identified conditions and events in the aggregate, the auditor believes there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, he or she follows the guidance in paragraphs

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[5] In a going-concern explanatory paragraph, the auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity's ability to continue as a going concern. Examples of inappropriate wording in the explanatory paragraph would be, "If the Company continues to suffer recurring losses from operations and continues to have a net capital deficiency, there may be substantial doubt about its ability to continue as a going concern" or "The Company has been unable to renegotiate its expiring credit agreements. Unless the Company is able to obtain financial support, there is substantial doubt about its ability to continue as a going concern." [Footnote added, effective for reports issued after December 15, 1995, by Statement on Auditing Standards No. 77.]

.07 through .16. In connection with that guidance, the auditor should document all of the following:

a. The conditions or events that led him or her to believe that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

b. The elements of management's plans that the auditor considered to be particularly significant to overcoming the adverse effects of the conditions or events.

c. The auditing procedures performed and evidence obtained to evaluate the significant elements of management's plans.

d. The auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated. If substantial doubt remains, the auditor also should document the possible effects of the conditions or events on the financial statements and the adequacy of the related disclosures. If substantial doubt is alleviated, the auditor also should document the conclusion as to the need for disclosure of the principal conditions and events that initially caused him or her to believe there was substantial doubt.

e. The auditor's conclusion as to whether he or she should include an explanatory paragraph in the audit report. If disclosures with respect to an entity's ability to continue as a going concern are inadequate, the auditor also should document the conclusion as to whether to express a qualified or adverse opinion for the resultant departure from generally accepted accounting principles.

[Paragraph added, effective for audits of financial statements for periods beginning on or after May 15, 2002, by Statement on Auditing Standards No. 96.]

Communications With Audit Committees

.17A *[The following paragraph and preceding heading is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

Paragraph 17 of Auditing Standard No. 16, *Communications with Audit Committees*, describes matters an auditor is required to communicate to the audit committee related to the auditor's evaluation of a company's ability to continue as a going concern for a reasonable period of time.

Effective Date

.18 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 96, January 2002.]

AU Section 9341

The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern: Auditing Interpretations of Section 341

1. Eliminating a Going-Concern Explanatory Paragraph From a Reissued Report

.01 *Question*—An auditor may be asked to reissue his or her report on financial statements and eliminate the going-concern explanatory paragraph that appeared in the original report. Such requests ordinarily occur after the conditions that gave rise to substantial doubt about the entity's ability to continue as a going concern have been resolved. For example, subsequent to the date of the auditor's original report, an entity might obtain needed financing. In such circumstances, may the auditor reissue his or her report and eliminate the going-concern explanatory paragraph that appeared in the original report?

.02 *Interpretation*—An auditor has no obligation to reissue his or her report.[1] However, if the auditor decides to reissue the report,[2] the auditor should perform the following procedures when determining whether to reissue the report without the going-concern explanatory paragraph that appeared in the original report:

- Audit the event or transaction that prompted the request to reissue the report without the going-concern explanatory paragraph.
- Perform the procedures listed in section 560, *Subsequent Events*, paragraph .12, at or near the date of reissuance.
- Consider the factors described in section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, paragraphs .06 through .11, based on the conditions and circumstances at the date of reissuance.

The auditor may perform any other procedures that he or she deems necessary in the circumstances. Based on the information that the auditor becomes aware of as a result of performing the procedures mentioned above, the auditor should reassess the going-concern status of the entity.

[Issue Date: August, 1995.]

[2.] Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern

[.03–.27] [Withdrawn July, 2000 by the Audit Issues Task Force.]

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[1] If the auditor decides not to reissue his or her report, the auditor may agree to be engaged to audit the financial statements for a period subsequent to that covered by the original report. This might be the case, for example, if the entity is experiencing profitable operations.

[2] Section 530, *Dating of the Independent Auditor's Report*, paragraph .05, states that an auditor may either "dual-date" or "later-date" his or her reissued report.

AU Section 342

Auditing Accounting Estimates

Source: SAS No. 57; Auditing Standard No. 5; Auditing Standard Nos. 8–15.

See section 9342 for interpretations of this section.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

.01 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

This section provides guidance to auditors on obtaining and evaluating sufficient appropriate evidential matter to support significant accounting estimates in an audit of financial statements in accordance with generally accepted auditing standards. For purposes of this section, an *accounting estimate* is an approximation of a financial statement element, item, or account. Accounting estimates are often included in historical financial statements because—

a. The measurement of some amounts or the valuation of some accounts is uncertain, pending the outcome of future events.

b. Relevant data concerning events that have already occurred cannot be accumulated on a timely, cost-effective basis.

.02 Accounting estimates in historical financial statements measure the effects of past business transactions or events, or the present status of an asset or liability. Examples of accounting estimates include net realizable values of inventory and accounts receivable, property and casualty insurance loss reserves, revenues from contracts accounted for by the percentage-of-completion method, and pension and warranty expenses.[1]

.03 Management is responsible for making the accounting estimates included in the financial statements. Estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate an amount at the date of the financial statements. Management's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take.

.04 The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. As estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them. Even when management's estimation process involves competent personnel using relevant and reliable data, there is potential for bias in the subjective factors. Accordingly, when planning and performing procedures to evaluate accounting estimates, the auditor should consider, with an attitude of professional skepticism, both the subjective and objective factors.

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[1] Additional examples of accounting estimates included in historical financial statements are presented in paragraph .16.

Developing Accounting Estimates

.05 Management is responsible for establishing a process for preparing accounting estimates. Although the process may not be documented or formally applied, it normally consists of—

a. Identifying situations for which accounting estimates are required.

b. Identifying the relevant factors that may affect the accounting estimate.

c. Accumulating relevant, sufficient, and reliable data on which to base the estimate.

d. Developing assumptions that represent management's judgment of the most likely circumstances and events with respect to the relevant factors.

e. Determining the estimated amount based on the assumptions and other relevant factors.

f. Determining that the accounting estimate is presented in conformity with applicable accounting principles and that disclosure is adequate.

The risk of material misstatement of accounting estimates normally varies with the complexity and subjectivity associated with the process, the availability and reliability of relevant data, the number and significance of assumptions that are made, and the degree of uncertainty associated with the assumptions.

Internal Control Related to Accounting Estimates

.06 An entity's internal control may reduce the likelihood of material misstatements of accounting estimates. Specific relevant aspects of internal control include the following:

a. Management communication of the need for proper accounting estimates

b. Accumulation of relevant, sufficient, and reliable data on which to base an accounting estimate

c. Preparation of the accounting estimate by qualified personnel

d. Adequate review and approval of the accounting estimates by appropriate levels of authority, including—

1. Review of sources of relevant factors
2. Review of development of assumptions
3. Review of reasonableness of assumptions and resulting estimates
4. Consideration of the need to use the work of specialists
5. Consideration of changes in previously established methods to arrive at accounting estimates

e. Comparison of prior accounting estimates with subsequent results to assess the reliability of the process used to develop estimates

f. Consideration by management of whether the resulting accounting estimate is consistent with the operational plans of the entity.

Evaluating Accounting Estimates

.07 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor's objective when evaluating accounting estimates is to obtain sufficient appropriate evidential matter to provide reasonable assurance that—

a. All accounting estimates that could be material to the financial statements have been developed.

b. Those accounting estimates are reasonable in the circumstances.

c. The accounting estimates are presented in conformity with applicable accounting principles[2] and are properly disclosed.[3]

Identifying Circumstances That Require Accounting Estimates

.08 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

In evaluating whether management has identified all accounting estimates that could be material to the financial statements, the auditor considers the circumstances of the industry or industries in which the entity operates, its methods of conducting business, new accounting pronouncements, and other external factors. The auditor should consider performing the following procedures:

a. Consider assertions embodied in the financial statements to determine the need for estimates. (See paragraph .16 for examples of accounting estimates included in financial statements.)

b. Evaluate information obtained in performing other procedures, such as—

1. Information about changes made or planned in the entity's business, including changes in operating strategy, and the industry in which the entity operates that may indicate the need to make an accounting estimate (Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*).
2. Changes in the methods of accumulating information.
3. Information concerning identified litigation, claims, and assessments (section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*), and other contingencies.
4. Information from reading available minutes of meetings of stockholders, directors, and appropriate committees.
5. Information contained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies.

c. Inquire of management about the existence of circumstances that may indicate the need to make an accounting estimate.

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[2] Section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, discusses the auditor's responsibility for evaluating conformity with generally accepted accounting principles. [Title of section 411 amended, effective for reports issued or reissued on or after June 30, 2001, by Statement on Auditing Standards No. 93.]

[3] See paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Evaluating Reasonableness

.09 In evaluating the reasonableness of an estimate, the auditor normally concentrates on key factors and assumptions that are—

a. Significant to the accounting estimate.

b. Sensitive to variations.

c. Deviations from historical patterns.

d. Subjective and susceptible to misstatement and bias.

The auditor normally should consider the historical experience of the entity in making past estimates as well as the auditor's experience in the industry. However, changes in facts, circumstances, or entity's procedures may cause factors different from those considered in the past to become significant to the accounting estimate.[4]

.10 In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches:

a. Review and test the process used by management to develop the estimate.

b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.

[The following subparagraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]

c. Review subsequent events or transactions occurring prior to the date of the auditor's report.

> Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may use any of the three approaches. However, the work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would be required to obtain an understanding of the process management used to develop the estimate and to test controls over all relevant assertions related to the estimate.

.11 Review and test management's process. In many situations, the auditor assesses the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. The following are procedures the auditor may consider performing when using this approach:

a. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation.

b. Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests.

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[4] In addition to other evidential matter about the estimate, in certain instances, the auditor may wish to obtain written representation from management regarding the key factors and assumptions.

c. Consider whether there are additional key factors or alternative assumptions about the factors.

d. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.

e. Analyze historical data used in developing the assumptions to assess whether the data is comparable and consistent with data of the period under audit, and consider whether such data is sufficiently reliable for the purpose.

f. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.

g. Review available documentation of the assumptions used in developing the accounting estimates and inquire about any other plans, goals, and objectives of the entity, as well as consider their relationship to the assumptions.

h. Consider using the work of a specialist regarding certain assumptions (section 336,*Using the Work of a Specialist).*

i. Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.

.12 *Develop an expectation.* Based on the auditor's understanding of the facts and circumstances, he may independently develop an expectation as to the estimate by using other key factors or alternative assumptions about those factors.

.13 *[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]*

Review subsequent events or transactions. Events or transactions sometimes occur subsequent to the date of the balance sheet, but prior to the date of the auditor's report, that are important in identifying and evaluating the reasonableness of accounting estimates or key factors or assumptions used in the preparation of the estimate. In such circumstances, an evaluation of the estimate or of a key factor or assumption may be minimized or unnecessary as the event or transaction can be used by the auditor in evaluating their reasonableness.

.14 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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.

Effective Date

.15 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

.16

Appendix

Examples of Accounting Estimates

The following are examples of accounting estimates that are included in financial statements. The list is presented for information only. It should not be considered all-inclusive.

Receivables:	Revenues:
Uncollectible receivables	Airline passenger revenue
Allowance for loan losses	Subscription income
Uncollectible pledges	Freight and cargo revenue
	Dues income
Inventories:	Losses on sales contracts
Obsolete inventory	
Net realizable value of inventories where future selling prices and future costs are involved	Contracts:
Losses on purchase commitments	Revenue to be earned
	Costs to be incurred
Financial instruments:	Percent of completion
Valuation of securities	
Trading versus investment security classification	Leases:
Probability of high correlation of a hedge	Initial direct costs
Sales of securities with puts and calls	Executory costs
	Residual values
Productive facilities, natural resources and intangibles:	
Useful lives and residual values	Litigation:
Depreciation and amortization methods	Probability of loss
Recoverability of costs	Amount of loss
Recoverable reserves	
	Rates:
Accruals:	Annual effective tax rate in interim reporting
Property and casualty insurance company loss reserves	Imputed interest rates on receivables and payables

Receivables:	Revenues:
Compensation in stock option plans and deferred plans	Gross profit rates under program method of accounting
Warranty claims	
Taxes on real and personal property	Other:
Renegotiation refunds	Losses and net realizable value on disposal of segment or restructuring of a business
Actuarial assumptions in pension costs	Fair values in nonmonetary exchanges
	Interim period costs in interim reporting
	Current values in personal financial statements

AU Section 9342

Auditing Accounting Estimates: Auditing Interpretations of Section 342

Source: Auditing Standard Nos. 8–15.

1. Performance and Reporting Guidance Related to Fair Value Disclosures

.01 *Question*—In December 1991, the Financial Accounting Standards Board (FASB) issued Statement No. 107, *Disclosures about Fair Value of Financial Instruments* [AC section F25], which requires all entities to disclose the fair value of certain financial instruments for which it is practicable to estimate fair value. Some entities may disclose the information required by FASB Statement No. 107 and also disclose voluntarily the fair value of assets and liabilities not encompassed by FASB Statement No. 107. What are the auditor's responsibilities in situations in which entities are disclosing required or both required and voluntary fair value financial information?

.02 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Interpretation—The auditor should determine whether the fair value disclosures represent only those required by FASB Statement No. 107 or whether additional voluntary fair value information has been disclosed by the entity. When auditing management's estimate of both required and voluntary fair value information, the auditor should obtain sufficient appropriate evidential matter to reasonably assure that—

- the valuation principles are acceptable, are being consistently applied, and are supported by the underlying documentation, and
- the method of estimation and significant assumptions used are properly disclosed.

If such assurance cannot be obtained, the auditor should evaluate whether the financial statements are materially affected by the departure from generally accepted accounting principles.

.03 *Required Information Presented*—When an entity discloses in its basic financial statements only information required by FASB Statement No. 107, the auditor may issue a standard unqualified opinion (assuming no other report modifications are necessary). The auditor may add an emphasis-of-matter paragraph describing the nature and possible range of such fair value information especially when management's best estimate of value is used in the absence of quoted market values (FASB Statement No. 107, paragraph 11 [AC section F25.115D]) and the range of possible values is significant. If the entity has not disclosed required fair value information, the auditor should evaluate whether the financial statements are materially affected by the departure from generally accepted accounting principles.

.04 *Required and Voluntary Information Presented*—When voluntary information is presented in addition to required information the auditor may audit the voluntary information only if both the following conditions exist:

- the measurement and disclosure criteria used to prepare the fair value financial information are reasonable
- competent persons using the measurement and disclosure criteria would ordinarily obtain materially similar measurements or disclosures.

In applying this guidance to fair value disclosures, the intention is that another auditor would reach similar conclusions regarding the reasonableness of the valuation or estimation techniques and methods used by the entity.

.05 Voluntary disclosures may supplement required disclosures in such a fashion as to constitute either a complete balance sheet (the fair value of all material items in the balance sheet) or a presentation of less than a complete balance sheet.

.06 When the audited disclosures constitute a complete balance sheet presentation, the auditor should add a paragraph to the report, similar to the following:

> We have also audited in accordance with auditing standards generally accepted in the United States of America the supplemental fair value balance sheet of ABC Company as of December 31, 20XX. As described in Note X, the supplemental fair value balance sheet has been prepared by management to present relevant financial information that is not provided by the historical-cost balance sheets and is not intended to be a presentation in conformity with generally accepted accounting principles. In addition, the supplemental fair value balance sheet does not purport to present the net realizable, liquidation, or market value of ABC Company as a whole. Furthermore, amounts ultimately realized by ABC Company from the disposal of assets may vary significantly from the fair values presented. In our opinion, the supplemental fair value balance sheet referred to above presents fairly, in all material respects, the information set forth therein as described in Note X.

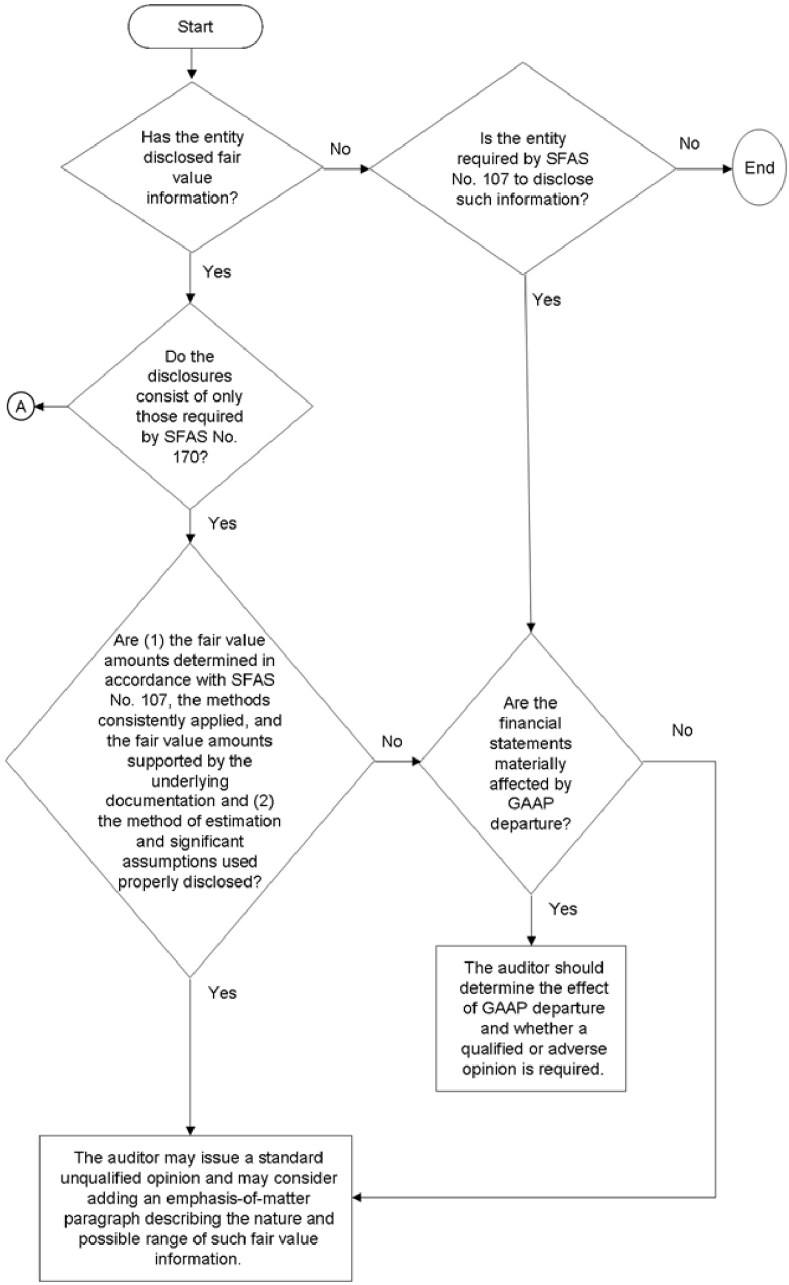
.07 When the audited disclosures do not constitute a complete balance sheet presentation and are located on the face of the financial statements or in the footnotes, the auditor may issue a standard unqualified opinion and need not mention the disclosures in the report. When the audited disclosures do not constitute a complete balance sheet presentation and are included in a supplemental schedule or exhibit, the auditor should add an additional paragraph to the report as discussed in section 551, *Reporting on Information Accompanying the Basic Financial Statements in the Auditor-Submitted Documents*, paragraph .12.

.08 In some situations, the auditor may not be engaged to audit the voluntary information or may be unable to audit it because it does not meet both conditions in paragraph .04 of this interpretation. When the unaudited voluntary disclosures are included in an auditor-submitted document and located on the face of the financial statements, the footnotes, or in a supplemental schedule to the basic financial statements, the voluntary disclosures should be labelled "unaudited" and the auditor should disclaim an opinion on the unaudited information as discussed in section 551.13.

.09 When the unaudited voluntary disclosures are included in a client-prepared document and are located on the face of the financial statements, the footnotes, or in a supplemental schedule, the voluntary disclosures should be labelled "unaudited." When such unaudited information is not presented on the face of the financial statements, the footnotes, or in a supplemental schedule, the auditor should consider the guidance in section 550, *Other Information in Documents Containing Audited Financial Statements*.

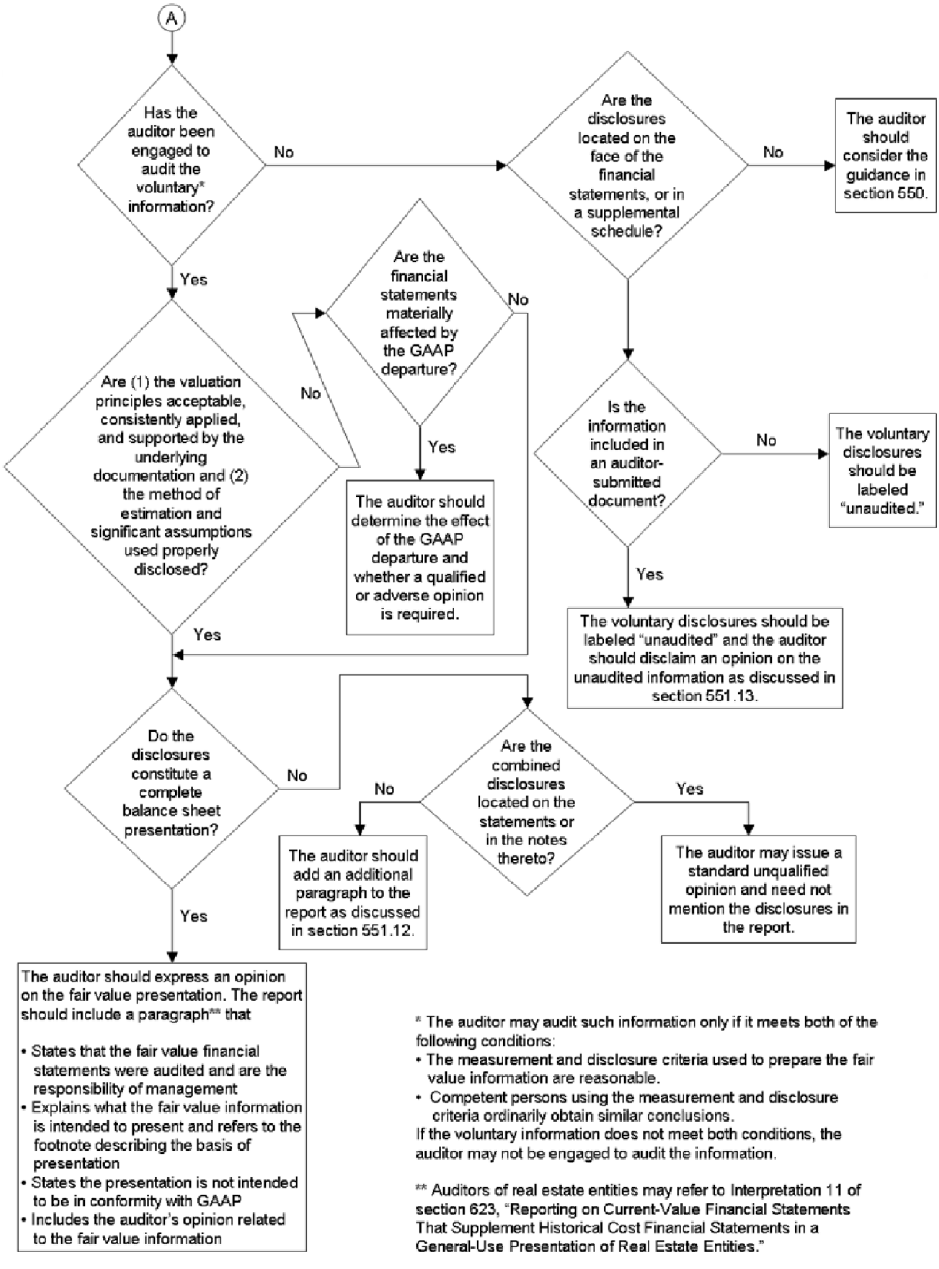
.10 The auditing guidance related to each of these alternatives is presented in the following flowcharts:

AUDITING GUIDANCE FOR FAIR VALUE INFORMATION
Required[*] Information Only



[*] Required by Statement of Financial Accounting Standards (SFAS) No. 107, *Disclosures about Fair Value of Financial Instruments*.

AUDITING GUIDANCE FOR FAIR VALUE INFORMATION
Required and Voluntary Information



[Issue Date: February, 1993; Revised: October, 2000.]

AU Section 350
Audit Sampling

(Supersedes Statement on Auditing Standards No. 1, sections 320A, and 320B.)

Source: SAS No. 39; SAS No. 43; SAS No. 45; Auditing Standard Nos. 8–15.

See section 9350 for interpretations of this section.

Effective for periods ended on or after June 25, 1983, unless otherwise indicated.

.01 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.[1] This section provides guidance for planning, performing, and evaluating audit samples.

.02 The auditor often is aware of account balances and transactions that may be more likely to contain misstatements.[2] He considers this knowledge in planning his procedures, including audit sampling. The auditor usually will have no special knowledge about other account balances and transactions that, in his judgment, will need to be tested to fulfill his audit objectives. Audit sampling is especially useful in these cases.

.03 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

There are two general approaches to audit sampling: nonstatistical and statistical. Both approaches require that the auditor use professional judgment in planning, performing, and evaluating a sample and in relating the evidential matter produced by the sample to other evidential matter when forming a conclusion about the related account balance or class of transactions. Either approach to audit sampling can provide sufficient evidential matter when applied properly. This section applies to both nonstatistical and statistical sampling.

[.04] *[Paragraph .04 deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

.05 The sufficiency of evidential matter is related to the design and size of an audit sample, among other factors. The size of a sample necessary to provide sufficient evidential matter depends on both the objectives and the efficiency of the sample. For a given objective, the efficiency of the sample relates to its design; one sample is more efficient than another if it can achieve the same objectives with a smaller sample size. In general, careful design can produce more efficient samples.

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[1] There may be other reasons for an auditor to examine less than 100 percent of the items comprising an account balance or class of transactions. For example, an auditor may examine only a few transactions from an account balance or class of transactions to (*a*) gain an understanding of the nature of an entity's operations or (*b*) clarify his understanding of the entity's internal control. In such cases, the guidance in this statement is not applicable.

[2] For purposes of this section the use of the term misstatement can include both errors and fraud as appropriate for the design of the sampling application. Errors and fraud are discussed in Auditing Standard No. 14, *Evaluating Audit Results*. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

.06 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

In a strict sense, the sample evaluation relates only to the likelihood that existing monetary misstatements or deviations from prescribed controls are proportionately included in the sample, not to the auditor's treatment of such items. Thus, the choice of nonstatistical or statistical sampling does not directly affect the auditor's decisions about the auditing procedures to be applied, the appropriateness of the evidential matter obtained with respect to individual items in the sample, or the actions that might be taken in light of the nature and cause of particular misstatements.

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.

Uncertainty and Audit Sampling

.07 Some degree of uncertainty is implicit in the concept of "a reasonable basis for an opinion" referred to in the third standard of field work. The justification for accepting some uncertainty arises from the relationship between such factors as the cost and time required to examine all of the data and the adverse consequences of possible erroneous decisions based on the conclusions resulting from examining only a sample of the data. If these factors do not justify the acceptance of some uncertainty, the only alternative is to examine all of the data. Since this is seldom the case, the basic concept of sampling is well established in auditing practice.

[.08] *[Paragraph .08 deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

.09 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Audit risk includes both uncertainties due to sampling and uncertainties due to factors other than sampling. These aspects of audit risk are sampling risk and nonsampling risk, respectively.

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.

.10 Sampling risk arises from the possibility that, when a test of controls or a substantive test is restricted to a sample, the auditor's conclusions may be different from the conclusions he would reach if the test were applied in the same way to all items in the account balance or class of transactions. That is, a particular sample may contain proportionately more or less monetary misstatements or deviations from prescribed controls than exist in the balance or class as a whole. For a sample of a specific design, sampling risk varies inversely with sample size: the smaller the sample size, the greater the sampling risk.

.11 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Nonsampling risk includes all the aspects of audit risk that are not due to sampling. An auditor may apply a procedure to all transactions or balances and still fail to detect a material misstatement. Nonsampling risk includes the possibility of selecting audit procedures that are not appropriate to achieve the specific objective. For example, confirming recorded receivables cannot be relied on to reveal unrecorded receivables. Nonsampling risk also arises because

the auditor may fail to recognize misstatements included in documents that he examines, which would make that procedure ineffective even if he were to examine all items. Nonsampling risk can be reduced to a negligible level through such factors as adequate planning and supervision and proper conduct of a firm's audit practice (see section 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards*).

Sampling Risk

.12 The auditor should apply professional judgment in assessing sampling risk. In performing substantive tests of details the auditor is concerned with two aspects of sampling risk:

- *The risk of incorrect acceptance* is the risk that the sample supports the conclusion that the recorded account balance is not materially misstated when it is materially misstated.
- *The risk of incorrect rejection* is the risk that the sample supports the conclusion that the recorded account balance is materially misstated when it is not materially misstated.

The auditor is also concerned with two aspects of sampling risk in performing tests of controls when sampling is used:

- *The risk of assessing control risk too low* is the risk that the assessed level of control risk based on the sample is less than the true operating effectiveness of the control.
- *The risk of assessing control risk too high* is the risk that the assessed level of control risk based on the sample is greater than the true operating effectiveness of the control.

.13 The risk of incorrect rejection and the risk of assessing control risk too high relate to the efficiency of the audit. For example, if the auditor's evaluation of an audit sample leads him to the initial erroneous conclusion that a balance is materially misstated when it is not, the application of additional audit procedures and consideration of other audit evidence would ordinarily lead the auditor to the correct conclusion. Similarly, if the auditor's evaluation of a sample leads him to unnecessarily assess control risk too high for an assertion, he would ordinarily increase the scope of substantive tests to compensate for the perceived ineffectiveness of the controls. Although the audit may be less efficient in these circumstances, the audit is, nevertheless, effective.

.14 The risk of incorrect acceptance and the risk of assessing control risk too low relate to the effectiveness of an audit in detecting an existing material misstatement. These risks are discussed in the following paragraphs.

Sampling in Substantive Tests of Details

Planning Samples

.15 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Planning involves developing a strategy for conducting an audit of financial statements. See Auditing Standard No. 9, *Audit Planning*.

.16 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

When planning a particular sample for a substantive test of details, the auditor should consider

- The relationship of the sample to the relevant audit objective.
- Tolerable misstatement. (See paragraphs .18–.18A.)
- The auditor's allowable risk of incorrect acceptance.
- Characteristics of the population, that is, the items comprising the account balance or class of transactions of interest.

.17 When planning a particular sample, the auditor should consider the specific audit objective to be achieved and should determine that the audit procedure, or combination of procedures, to be applied will achieve that objective. The auditor should determine that the population from which he draws the sample is appropriate for the specific audit objective. For example, an auditor would not be able to detect understatements of an account due to omitted items by sampling the recorded items. An appropriate sampling plan for detecting such understatements would involve selecting from a source in which the omitted items are included. To illustrate, subsequent cash disbursements might be sampled to test recorded accounts payable for understatement because of omitted purchases, or shipping documents might be sampled for understatement of sales due to shipments made but not recorded as sales.

.18 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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*.

.18A *[The following paragraph is added and effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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.

.19 The second standard of field work states, "A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed." After assessing and considering the levels of inherent and control risks, the auditor performs substantive tests to restrict detection risk to an acceptable level. As the assessed levels of inherent risk, control risk, and detection risk for other substantive procedures directed toward the same specific audit objective decreases, the auditor's allowable risk of incorrect acceptance for the substantive

tests of details increases and, thus, the smaller the required sample size for the substantive tests of details. For example, if inherent and control risks are assessed at the maximum, and no other substantive tests directed toward the same specific audit objectives are performed, the auditor should allow for a low risk of incorrect acceptance for the substantive tests of details.[3] Thus, the auditor would select a larger sample size for the tests of details than if he allowed a higher risk of incorrect acceptance.

[.20] *[Paragraph .20 deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

.21 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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. When planning a sample for a substantive test of details, the auditor uses his judgment to determine which items, if any, in an account balance or class of transactions should be individually examined and which items, if any, should be subject to sampling. The auditor should examine those items for which, in his judgment, acceptance of some sampling risk is not justified. For example, these may include items for which potential misstatements could individually equal or exceed the tolerable misstatement. Any items that the auditor has decided to examine 100 percent are not part of the items subject to sampling. Other items that, in the auditor's judgment, need to be tested to fulfill the audit objective but need not be examined 100 percent, would be subject to sampling.

.22 The auditor may be able to reduce the required sample size by separating items subject to sampling into relatively homogeneous groups on the basis of some characteristic related to the specific audit objective. For example, common bases for such groupings are the recorded or book value of the items, the nature of controls related to processing the items, and special considerations associated with certain items. An appropriate number of items is then selected from each group.

.23 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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.

.23A *[The following paragraph is added and effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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

[3] Some auditors prefer to think of risk levels in quantitative terms. For example, in the circumstances described, an auditor might think in terms of a 5 percent risk of incorrect acceptance for the substantive test of details. Risk levels used in sampling applications in other fields are not necessarily relevant in determining appropriate levels for applications in auditing because an audit includes many interrelated tests and sources of evidence.

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.

Sample Selection

.24 Sample items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an opportunity to be selected. For example, haphazard and random-based selection of items represents two means of obtaining such samples.[4]

Performance and Evaluation

.25 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Auditing procedures that are appropriate to the particular audit objective should be applied to each sample item. In some circumstances the auditor may not be able to apply the planned audit procedures to selected sample items because, for example, supporting documentation may be missing. The auditor's treatment of unexamined items will depend on their effect on his evaluation of the sample. If the auditor's evaluation of the sample results would not be altered by considering those unexamined items to be misstated, it is not necessary to examine the items. However, if considering those unexamined items to be misstated would lead to a conclusion that the balance or class contains material misstatement, the auditor should consider alternative procedures that would provide him with sufficient evidence to form a conclusion. 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.

.26 The auditor should project the misstatement results of the sample to the items from which the sample was selected.[5] [6] There are several acceptable ways to project misstatements from a sample. For example, an auditor may have selected a sample of every twentieth item (50 items) from a population containing one thousand items. If he discovered overstatements of $3,000 in that sample, the auditor could project a $60,000 overstatement by dividing the amount of misstatement in the sample by the fraction of total items from the population included in the sample. The auditor should add that projection to the misstatements discovered in any items examined 100 percent. This total projected misstatement should be compared with the tolerable misstatement for the account balance or class of transactions, and appropriate consideration should be given to sampling risk. If the total projected misstatement is less than tolerable misstatement for the account balance or class of transactions,

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[4] Random-based selection includes, for example, random sampling, stratified random sampling, sampling with probability proportional to size, and systematic sampling (for example, every hundredth item) with one or more random starts.

[5] If the auditor has separated the items subject to sampling into relatively homogeneous groups (see paragraph .22), he separately projects the misstatement results of each group and sums them.

[6] 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. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

the auditor should consider the risk that such a result might be obtained even though the true monetary misstatement for the population exceeds tolerable misstatement. For example, if the tolerable misstatement in an account balance of $1 million is $50,000 and the total projected misstatement based on an appropriate sample (see paragraph .23) is $10,000, he may be reasonably assured that there is an acceptably low sampling risk that the true monetary misstatement for the population exceeds tolerable misstatement. On the other hand, if the total projected misstatement is close to the tolerable misstatement, the auditor may conclude that there is an unacceptably high risk that the actual misstatements in the population exceed the tolerable misstatement. An auditor uses professional judgment in making such evaluations.

.27 In addition to the evaluation of the frequency and amounts of monetary misstatements, consideration should be given to the qualitative aspects of the misstatements. These include (*a*) the nature and cause of misstatements, such as whether they are differences in principle or in application, are errors or are caused by fraud, or are due to misunderstanding of instructions or to carelessness, and (*b*) the possible relationship of the misstatements to other phases of the audit. The discovery of fraud ordinarily requires a broader consideration of possible implications than does the discovery of an error.

.28 If the sample results suggest that the auditor's planning assumptions were incorrect, he should take appropriate action. For example, if monetary misstatements are discovered in a substantive test of details in amounts or frequency that is greater than is consistent with the assessed levels of inherent and control risk, the auditor should alter his risk assessments. The auditor should also consider whether to modify the other audit tests that were designed based upon the inherent and control risk assessments. For example, a large number of misstatements discovered in confirmation of receivables may indicate the need to reconsider the control risk assessment related to the assertions that impacted the design of substantive tests of sales or cash receipts.

.29 The auditor should relate the evaluation of the sample to other relevant audit evidence when forming a conclusion about the related account balance or class of transactions.

.30 Projected misstatement results for all audit sampling applications and all known misstatements from nonsampling applications should be considered in the aggregate along with other relevant audit evidence when the auditor evaluates whether the financial statements taken as a whole may be materially misstated.

Sampling in Tests of Controls

Planning Samples

.31 When planning a particular audit sample for a test of controls, the auditor should consider

- The relationship of the sample to the objective of the test of controls.
- The maximum rate of deviations from prescribed controls that would support his planned assessed level of control risk.
- The auditor's allowable risk of assessing control risk too low.
- Characteristics of the population, that is, the items comprising the account balance or class of transactions of interest.

.32 For many tests of controls, sampling does not apply. Procedures performed to obtain an understanding of internal control sufficient to plan an audit do not involve sampling.[7] Sampling generally is not applicable to tests of controls that depend primarily on appropriate segregation of duties or that otherwise provide no documentary evidence of performance. In addition, sampling may not apply to tests of certain documented controls. Sampling may not apply to tests directed toward obtaining evidence about the design or operation of the control environment or the accounting system. For example, inquiry or observation of explanation of variances from budgets when the auditor does not desire to estimate the rate of deviation from the prescribed control.

.33 When designing samples for tests of controls the auditor ordinarily should plan to evaluate operating effectiveness in terms of deviations from prescribed controls, as to either the rate of such deviations or the monetary amount of the related transactions.[8] In this context, pertinent controls are ones that, had they not been included in the design of internal control would have adversely affected the auditor's planned assessed level of control risk. The auditor's overall assessment of control risk for a particular assertion involves combining judgments about the prescribed controls, the deviations from prescribed controls, and the degree of assurance provided by the sample and other tests of controls.

.34 The auditor should determine the maximum rate of deviations from the prescribed control that he would be willing to accept without altering his planned assessed level of control risk. This is the *tolerable rate*. In determining the tolerable rate, the auditor should consider (*a*) the planned assessed level of control risk, and (*b*) the degree of assurance desired by the evidential matter in the sample. For example, if the auditor plans to assess control risk at a low level, and he desires a high degree of assurance from the evidential matter provided by the sample for tests of controls (i.e., not perform other tests of controls for the assertion), he might decide that a tolerable rate of 5 percent or possibly less would be reasonable. If the auditor either plans to assess control risk at a higher level, or he desires assurance from other tests of controls along with that provided by the sample (such as inquiries of appropriate entity personnel or observation of the application of the policy or procedure), the auditor might decide that a tolerable rate of 10 percent or more is reasonable.

.35 In assessing the tolerable rate of deviations, the auditor should consider that, while deviations from pertinent controls increase the risk of material misstatements in the accounting records, such deviations do not necessarily result in misstatements. For example, a recorded disbursement that does not show evidence of required approval may nevertheless be a transaction that is properly authorized and recorded. Deviations would result in misstatements in the accounting records only if the deviations and the misstatements occurred on the same transactions. Deviations from pertinent controls at a given rate ordinarily would be expected to result in misstatements at a lower rate.

.36 In some situations, the risk of material misstatement for an assertion may be related to a combination of controls. If a combination of two or more controls is necessary to affect the risk of material misstatement for an assertion,

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[7] The auditor may plan to perform tests of controls concurrently with obtaining an understanding of internal control for the purpose of estimating the rate of deviation from the prescribed controls, as to either the rate of such deviations or monetary amount of the related transactions. Sampling, as defined in this section, applies to such tests of controls. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[8] For simplicity the remainder of this section will refer to only the rate of deviations.

those controls should be regarded as a single procedure, and deviations from any controls in combination should be evaluated on that basis.

.37 Samples taken to test the operating effectiveness of controls are intended to provide a basis for the auditor to conclude whether the controls are being applied as prescribed. When the degree of assurance desired by the evidential matter in the sample is high, the auditor should allow for a low level of sampling risk (that is, the risk of assessing control risk too low).[9]

.38 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

To determine the number of items to be selected for a particular sample for a test of controls, the auditor should consider the tolerable rate of deviation from the controls being tested, the likely rate of deviations, and the allowable risk of assessing control risk too low. 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.

Sample Selection

.39 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Sample items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an opportunity to be selected. Random-based selection of items represents one means of obtaining such samples. Ideally, the auditor should use a selection method that has the potential for selecting items from the entire period under audit. 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.

Performance and Evaluation

.40 Auditing procedures that are appropriate to achieve the objective of the test of controls should be applied to each sample item. If the auditor is not able to apply the planned audit procedures or appropriate alternative procedures to selected items, he should consider the reasons for this limitation, and he should ordinarily consider those selected items to be deviations from the prescribed policy or procedure for the purpose of evaluating the sample.

.41 The deviation rate in the sample is the auditor's best estimate of the deviation rate in the population from which it was selected. If the estimated deviation rate is less than the tolerable rate for the population, the auditor should consider the risk that such a result might be obtained even though the true deviation rate for the population exceeds the tolerable rate for the population. For example, if the tolerable rate for a population is 5 percent and no deviations are found in a sample of 60 items, the auditor may conclude that there is an acceptably low sampling risk that the true deviation rate in the population exceeds the tolerable rate of 5 percent. On the other hand, if the

[9] The auditor who prefers to think of risk levels in quantitative terms might consider, for example, a 5 percent to 10 percent risk of assessing control risk too low.

sample includes, for example, two or more deviations, the auditor may conclude that there is an unacceptably high sampling risk that the rate of deviations in the population exceeds the tolerable rate of 5 percent. An auditor applies professional judgment in making such an evaluation.

.42 In addition to the evaluation of the frequency of deviations from pertinent procedures, consideration should be given to the qualitative aspects of the deviations. These include (*a*) the nature and cause of the deviations, such as whether they are errors or irregularities or are due to misunderstanding of instructions or to carelessness, and (*b*) the possible relationship of the deviations to other phases of the audit. The discovery of an irregularity ordinarily requires a broader consideration of possible implications than does the discovery of an error.

.43 If the auditor concludes that the sample results do not support the planned assessed level of control risk for an assertion, he should re-evaluate the nature, timing, and extent of substantive procedures based on a revised consideration of the assessed level of control risk for the relevant financial statement assertions.

Dual-Purpose Samples

.44 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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. In general, an auditor planning to use a dual-purpose sample would have made a preliminary assessment that there is an acceptably low risk that the rate of deviations from the prescribed control in the population exceeds the tolerable rate. 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 size of a sample designed for dual purposes should be the larger of the samples that would otherwise have been designed for the two separate purposes. 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.

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.

Selecting a Sampling Approach

.45 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

As discussed in paragraph .03, either a nonstatistical or statistical approach to audit sampling, when properly applied, can provide sufficient evidential matter.

.46 Statistical sampling helps the auditor (*a*) to design an efficient sample, (*b*) to measure the sufficiency of the evidential matter obtained, and (*c*) to evaluate the sample results. By using statistical theory, the auditor can quantify sampling risk to assist himself in limiting it to a level he considers acceptable. However, statistical sampling involves additional costs of training auditors, designing individual samples to meet the statistical requirements, and selecting the items to be examined. Because either nonstatistical or statistical sampling

can provide sufficient evidential matter, the auditor chooses between them after considering their relative cost and effectiveness in the circumstances.

Effective Date

.47 This section is effective for audits of financial statements for periods ended on or after June 25, 1983. Earlier application is encouraged. [As amended, effective retroactively to June 25, 1982, by Statement on Auditing Standards No. 43.]

.48

Appendix

Relating the Risk of Incorrect Acceptance for a Substantive Test of Details to Other Sources of Audit Assurance

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]

1. Audit risk, with respect to a particular account balance or class of transactions, is the risk that there is a monetary misstatement greater than tolerable misstatement affecting an assertion in an account balance or class of transactions that the auditor fails to detect. The auditor uses professional judgment in determining the allowable risk for a particular audit after he consider such factors as the risk of material misstatement in the financial statements, the cost to reduce the risk, and the effect of the potential misstatements on the use and understanding of the financial statements.

2. An auditor assesses inherent and control risk, and plans and performs substantive tests (analytical procedures and substantive tests of details) in whatever combination to reduce audit risk to an appropriate level.

3. The sufficiency of audit sample sizes, whether nonstatistical or statistical, is influenced by several factors. Table 1 illustrates how several of these factors may affect sample sizes for a substantive test of details. Factors *a*, *b* and *c* in table 1 should be considered together (see paragraph .08). For example, high inherent risk, the lack of effective controls, and the absence of other substantive tests related to the same audit objective ordinarily require larger sample sizes for related substantive tests of details than if there were other sources to provide the basis for assessing inherent or control risks below the maximum, or if other substantive tests related to the same objective were performed. Alternatively, low inherent risk, effective controls, or effective analytical procedures and other relevant substantive tests may lead the auditor to conclude that the sample, if any, needed for an additional test of details can be small.

4. The following model expresses the general relationship of the risks associated with the auditor's assessment of inherent and control risks, and the effectiveness of analytical procedures (including other relevant substantive tests) and substantive tests of details. The model is not intended to be a mathematical formula including all factors that may influence the determination of individual risk components; however, some auditors find such a model to be useful when planning appropriate risk levels for audit procedures to achieve the auditor's desired audit risk.

$$AR = IR \times CR \times AP \times TD$$

An auditor might use this model to obtain an understanding of an appropriate risk of incorrect acceptance for a substantive test of details as follows:

$$TD = AR/(IR \times CR \times AP)$$

AR = The allowable audit risk that monetary misstatements equal to tolerable misstatement might remain undetected for the account balance or class of transactions and related assertions after the

auditor has completed all audit procedures deemed necessary.[1] The auditor uses his professional judgment to determine the allowable audit risk after considering factors such as those discussed in paragraph 1 of this appendix.

IR = Inherent risk is the susceptibility of an assertion to a material misstatement assuming there are no related internal control structure policies or procedures.

CR = Control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's controls. The auditor may assess control risk at the maximum, or assess control risk below the maximum based on the sufficiency of evidential matter obtained to support the effectiveness of controls. The quantification for this model relates to the auditor's evaluation of the overall effectiveness of those controls that would prevent or detect material misstatements equal to tolerable misstatement in the related account balance or class of transactions. For example, if the auditor believes that pertinent controls would prevent or detect misstatements equal to tolerable misstatement about half the time, he would assess this risk as 50 percent. (CR is not the same as the risk of assessing control risk too low.)

AP = The auditor's assessment of the risk that analytical procedures and other relevant substantive tests would fail to detect misstatements that could occur in an assertion equal to tolerable misstatement, given that such misstatements occur and are not detected by the internal control structure.

TD = The allowable risk of incorrect acceptance for the substantive test of details, given that misstatements equal to tolerable misstatement occur in an assertion and are not detected by internal control or analytical procedures and other relevant substantive tests.

5. The auditor planning a statistical sample can use the relationship in paragraph 4 of this Appendix to assist in planning his allowable risk of incorrect acceptance for a specific substantive test of details. To do so, he selects an acceptable audit risk (AR), and substantively quantifies his judgment of risks IR, CR and AP. Some levels of these risks are implicit in evaluating audit evidence and reaching conclusions. Auditors using the relationship prefer to evaluate these judgment risks explicitly.

6. The relationships between these independent risks are illustrated in table 2. In table 2 it is assumed, for illustrative purposes, that the auditor has chosen an audit risk of 5 percent for an assertion where inherent risk has been assessed at the maximum. Table 2 incorporates the premise that no internal control can be expected to be completely effective in detecting aggregate misstatements equal to tolerable misstatement that might occur. The table also illustrates the fact that the risk level for substantive tests for particular assertions is not an isolated decision. Rather, it is a direct consequence of the auditor's assessments of inherent and control risks, and judgments about the effectiveness of

[1] For purposes of this Appendix, the nonsampling risk aspect of audit risk is assumed to be negligible, based on the level of quality controls in effect. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

analytical procedures and other relevant substantive tests, and it cannot be properly considered out of this context.

Table 1

Factors Influencing Sample Sizes for a Substantive Test of Details in Sample Planning

	Conditions leading to		
Factor	*Smaller sample size*	*Larger sample size*	*Related factor for substantive sample planning*
a. Assessment of inherent risk.	Low assessed level of inherent risk.	High assessed level of inherent risk.	Allowable risk of incorrect acceptance.
b. Assessment of control risk.	Low assessed level of control risk.	High assessed level of control risk.	Allowable risk of incorrect acceptance.
c. Assessment of risk for other substantive tests related to the same assertion (including analytical procedures and other relevant substantive tests).	Low assessment of risk associated with other relevant substantive tests.	High assessment of risk associated with other relevant substantive tests.	Allowable risk of incorrect acceptance.
d. Measure of tolerable misstatement for a specific account.	Larger measure of tolerable misstatement.	Smaller measure of tolerable misstatement.	Tolerable misstatement.
e. Expected size and frequency of misstatements.	Smaller misstatements or lower frequency.	Larger misstatements or higher frequency.	Assessment of population characteristics.
f. Number of items in the population.	Virtually no effect on sample size unless population is very small.		

Table 2

Allowable Risk of Incorrect Acceptance (TD)
for Various Assessments of CR and AP; for AR = .05 and IR = 1.0

Auditor's subjective assessment control risk.	Auditor's subjective assessment of risk that analytical procedures and other relevant substantive tests might fail to detect aggregate misstatements equal to tolerable misstatement.			
CR	*AP*			
	10%	*30%*	*50%*	*100%*
	TD			
10%	*	*	*	50%
30%	*	55%	33%	16%
50%	*	33%	20%	10%
100%	50%	16%	10%	5%

* The allowable level of AR of 5 percent exceeds the product of IR, CR, and AP, and thus, the planned substantive test of details may not be necessary.

Note: The table entries for TD are computed from the illustrated model: TD equals AR/(IR x CR x AP). For example, for IR = 1.0, CR = .50, AP = .30, TD = .05/(1.0 x .50 x .30) or .33 (equals 33%).

AU Section 9350

Audit Sampling: Auditing Interpretations of Section 350

[This section was superseded, effective December 15, 2010, by PCAOB Auditing Standard Nos. 8–15. See PCAOB Release No. 2010-004.]

AU Section 380

Communication With Audit Committees

[This section was superseded, effective December 15, 2012, by PCAOB Auditing Standard No. 16. See PCAOB Release No. 2012-004.]

AU Section 9380

Communication With Audit Committees: Auditing Interpretations of Section 380

[This section was superseded, effective December 15, 2012, by PCAOB Auditing Standard No. 16. See PCAOB Release No. 2012-004.]

AU Section 390

Consideration of Omitted Procedures After the Report Date

Source: SAS No. 46.

Effective, unless otherwise indicated: October 31, 1983.

.01 This section provides guidance on the considerations and procedures to be applied by an auditor who, subsequent to the date of his report on audited financial statements, concludes that one or more auditing procedures considered necessary at the time of the audit in the circumstances then existing were omitted from his audit of the financial statements, but there is no indication that those financial statements are not fairly presented in conformity with generally accepted accounting principles or with another comprehensive basis of accounting.[1] This circumstance should be distinguished from that described in section 561, which applies if an auditor, subsequent to the date of his report on audited financial statements, becomes aware that facts regarding those financial statements may have existed at that date that might have affected his report had he then been aware of them.

.02 Once he has reported on audited financial statements, an auditor has no responsibility to carry out any retrospective review of his work. However, reports and working papers relating to particular engagements may be subjected to post-issuance review in connection with a firm's internal inspection program,[2] peer review, or otherwise, and the omission of a necessary auditing procedure may be disclosed.

.03 A variety of conditions might be encountered in which an auditing procedure considered necessary at the time of the audit in the circumstances then existing has been omitted; therefore, the considerations and procedures described herein necessarily are set forth only in general terms. The period of time during which the auditor considers whether this section applies to the circumstances of a particular engagement and then takes the actions, if any, that are required hereunder may be important. Because of legal implications that may be involved in taking the actions contemplated herein, the auditor would be well advised to consult with his attorney when he encounters the circumstances to which this section may apply, and, with the attorney's advice and assistance, determine an appropriate course of action.

.04 When the auditor concludes that an auditing procedure considered necessary at the time of the audit in the circumstances then existing was omitted from his audit of financial statements, he should assess the importance of the omitted procedure to his present ability to support his previously expressed opinion regarding those financial statements taken as a whole. A review of his

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[1] The provisions of this section are not intended to apply to an engagement in which an auditor's work is at issue in a threatened or pending legal proceeding or regulatory investigation. (A *threatened legal proceeding* means that a potential claimant has manifested to the auditor an awareness of, and present intention to assert, a possible claim.)

[2] See section 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards*, paragraph .02, and related quality control standards regarding the quality control function of inspection.

working papers, discussion of the circumstances with engagement personnel and others, and a re-evaluation of the overall scope of his audit may be helpful in making this assessment. For example, the results of other procedures that were applied may tend to compensate for the one omitted or make its omission less important. Also, subsequent audits may provide audit evidence in support of the previously expressed opinion.

.05 If the auditor concludes that the omission of a procedure considered necessary at the time of the audit in the circumstances then existing impairs his present ability to support his previously expressed opinion regarding the financial statements taken as a whole, and he believes there are persons currently relying, or likely to rely, on his report, he should promptly undertake to apply the omitted procedure or alternative procedures that would provide a satisfactory basis for his opinion.

.06 When as a result of the subsequent application of the omitted procedure or alternative procedures, the auditor becomes aware that facts regarding the financial statements existed at the date of his report that would have affected that report had he been aware of them, he should be guided by the provisions of section 561.05–.09.

.07 If in the circumstances described in paragraph .05, the auditor is unable to apply the previously omitted procedure or alternative procedures, he should consult his attorney to determine an appropriate course of action concerning his responsibilities to his client, regulatory authorities, if any, having jurisdiction over the client, and persons relying, or likely to rely, on his report.

Effective Date

.08 This section is effective as of October 31, 1983.

AU Section 400

THE FIRST, SECOND, AND THIRD STANDARDS OF REPORTING

TABLE OF CONTENTS

AU Section 410

Adherence to Generally Accepted Accounting Principles

Source: SAS No. 1, section 410; SAS No. 62; Auditing Standard No. 6.

See section 9410 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

.01 The first standard of reporting is:

> The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

.02 *[The following paragraph is effective November 15, 2008. See PCAOB Release 2008-001.]*

The fourth standard of reporting is:

The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.[1]

[.03–.04] [Superseded July 1975 by Statement on Auditing Standards No. 5, as superseded by section 411.]

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[1] When an auditor reports on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the first standard of reporting is satisfied by disclosing in the auditor's report that the statements have been prepared in conformity with another comprehensive basis of accounting other than generally accepted accounting principles and by expressing an opinion (or disclaiming an opinion) on whether the financial statements are presented in conformity with the comprehensive basis of accounting used (see section 623, *Special Reports*, paragraphs .02-.10).

AU Section 9410

Adherence to Generally Accepted Accounting Principles: Auditing Interpretations of Section 410

[1.] Accounting Principles Recommended by Trade Associations[1]

[.01–.03] [Withdrawn August, 1982 by Statement on Auditing Standards No. 43.]

[2.] The Impact of FASB Statement No. 2 on Auditor's Report Issued Prior to the Statement's Effective Date[2]

[.04–.12] [Superseded October, 1979 by Interpretation No. 3, paragraphs .13–.18.]

3. The Impact on an Auditor's Report of an FASB Statement Prior to the Statement's Effective Date

.13 *Question*—What is the impact on the auditor's report when he is reporting on financial statements issued before the effective date of a Statement of Financial Accounting Standards and the financial statements will have to be restated in the future because the FASB statement will require retroactive application of its provisions by prior period adjustment?

.14 *Interpretation*—Where the accounting principles being followed are currently acceptable, the auditor should not qualify his opinion if a company does not adopt before an FASB Statement becomes effective accounting principles that will be prescribed by that Statement. For example, Financial Accounting Standards Board Statement No. 2 [AC section R50], *Accounting for Research and Development Costs*, was issued in October 1974, but was effective for fiscal years beginning on or after January 1, 1975. This Statement requires companies to expense research and development costs encompassed by the Statement in the period they are incurred. Companies that had deferred research and development costs were required to restate their financial statements by prior period adjustment in the period in which FASB Statement No. 2 [AC section R50] became effective. Deferring research and development costs before FASB Statement No. 2 [AC section R50] became effective was an acceptable alternative principle under GAAP, although FASB Statement No. 2 [AC section R50] proscribed such treatment for fiscal years beginning on or after January 1, 1975. Other reporting considerations are addressed in the following paragraphs.

.15 Section 508, *Reports on Audited Financial Statements*, paragraph .41 states: "Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include related notes)." For financial statements that are

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[1] [Footnote deleted.]

[2] Originally issued under the title "Effect on the Auditor's Opinion of FASB Statement on Research and Development Costs" (*Journal of Accountancy*, Jan. '75, p. 74).

prepared on the basis of accounting principles that are acceptable at the financial-statement date but that will not be acceptable in the future, the auditor should consider whether disclosure of the impending change in principle and the resulting restatement are essential data. If he decides that the matter should be disclosed and it is not, the auditor should express a qualified or adverse opinion as to conformity with GAAP, as required by section 508.41.

.16 To evaluate the adequacy of disclosure of the prospective change in principle, the auditor should assess the potential effect on the financial statements. Using the research and development cost example given above, the effect of the anticipated prior period adjustment to write off previously deferred research and development costs would in some instances be so material that disclosure would be essential for an understanding of the financial statements. In cases such as this, where the estimated impact is so material, disclosure can best be made by supplementing the historical financial statements with pro forma financial data that give effect to the future adjustment as if it had occurred on the date of the balance sheet. (See section 560.05.) The pro forma data may be presented in columnar form alongside the historical statements, in the notes to the historical statements, or in separate pro forma statements presented with the historical statements.

.17 The auditor also should consider whether disclosure is needed for other effects that may result upon the required future adoption of an accounting principle. For example, the future adoption of such a principle may result in a reduction to stockholders' equity that may cause the company to be in violation of its debt covenants, which in turn may accelerate the due date for repayment of debt.

.18 Even if the auditor decides that the disclosure of the forthcoming change and its effects are adequate and, consequently, decides not to qualify his opinion, he nevertheless may decide to include an explanatory paragraph in his report if the effects of the change are expected to be unusually material. The explanatory paragraph should not be construed as a qualification of the auditor's opinion; it is intended to highlight circumstances of particular importance and to aid in interpreting the financial statements (see section 508.19).

[Issue Date: October, 1979; Revised: December, 1992;
Revised: June, 1993; Revised: February, 1997.]

AU Section 411

The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*

(Supersedes SAS No. 5)

Source: SAS No. 69; SAS No. 91; SAS No. 93; Auditing Standard No. 6; Auditing Standard Nos. 8–15.

See section 9411 for interpretations of this section.

Effective for audits of financial statements for periods ending after March 15, 1992, unless otherwise indicated.

.01 *[The following paragraph is effective November 15, 2008. See PCAOB Release 2008-001.]*

An independent auditor's report contains an opinion as to whether the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. An identification of the country of origin of those generally accepted accounting principles also is required (see section 508.08*h*).

The purpose of this section is to explain the meaning of "present fairly" as used in the phrase "present fairly . . . in conformity with generally accepted accounting principles." In applying this section, 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.

[.02] *[Paragraph .02 deleted, effective November 15, 2008. See PCAOB Release 2008-001.]*

.03 The independent auditor's judgment concerning the "fairness" of the overall presentation of financial statements should be applied within the framework of generally accepted accounting principles. Without that framework, the auditor would have no uniform standard for judging the presentation of financial position, results of operations, and cash flows in financial statements.

.04 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor's opinion that financial statements present fairly an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles should be based on his or her judgment as to whether (*a*) the accounting principles selected and applied have general acceptance; (*b*) the accounting principles are appropriate in the circumstances; (*c*) the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation (see paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*); (*d*) the information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed (see paragraph

* Title amended, effective for reports issued or reissued on or after June 30, 2001, by Statement on Auditing Statements No. 93.

31 of Auditing Standard No. 14); and (*e*) the financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.[1]

[.05] *[Paragraph .05 deleted, effective November 15, 2008. See PCAOB Release 2008-001.]*

.06 Generally accepted accounting principles recognize the importance of reporting transactions and events in accordance with their substance. The auditor should consider whether the substance of transactions or events differs materially from their form.

[.07] *[Paragraph .07 deleted, effective November 15, 2008. See PCAOB Release 2008-001.]*

.08 The auditor should be aware that the accounting requirements adopted by regulatory agencies for reports filed with them may differ from generally accepted accounting principles in certain respects. Section 544, *Lack of Conformity With Generally Accepted Accounting Principles*, paragraph .04 and section 623, *Special Reports* provide guidance if the auditor is reporting on financial statements prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles.

[.09–.18] *[Paragraphs .09–.18 deleted, effective November 15, 2008. See PCAOB Release 2008-001.]*

[1] The concept of materiality is inherent in the auditor's judgments. That concept involves qualitative as well as quantitative judgments (see sections 150.04, Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, and 508.36). *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

AU Section 9411

The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles: *Auditing Interpretations of Section 411*

[AU sec. 9411 deleted, effective November 15, 2008. See PCAOB Release 2008-001.]

AU Section 420

Consistency of Application of Generally Accepted Accounting Principles

[Superseded by PCAOB Auditing Standard No. 6, Evaluating Consistency of Financial Statements*, effective November 15, 2008. See PCAOB Release 2008-001.]*

AU Section 9420

Consistency of Application of Generally Accepted Accounting Principles: Auditing Interpretations of Section 420

[Superseded by PCAOB Auditing Standard No. 6, Evaluating Consistency of Financial Statements, effective November 15, 2008. See PCAOB Release 2008-001.]

AU Section 431

Adequacy of Disclosure in Financial Statements

[This section was superseded, effective December 15, 2010, by PCAOB Auditing Standard Nos. 8–15. See PCAOB Release No. 2010-004.]

AU Section 435

Segment Information

Source: SAS No. 21.

Notice of Rescission of Statement on Auditing Standards (SAS) No. 21, *Segment Information, and Issuance of Interpretation on Auditing Procedures for Segment Disclosures*

The Auditing Standards Board (ASB) has rescinded SAS No. 21, Segment Information, effective for audits of financial statements to which Financial Accounting Standards Board (FASB) Statement No. 131, Disclosures about Segments of an Enterprise and Related Information, has been applied. FASB Statement No. 131 is effective for fiscal years beginning after December 15, 1997, with earlier application encouraged.

SAS No. 21 was issued in December 1977 to provide guidance to auditors on audit issues related to the implementation of FASB Statement No. 14, Financial Reporting for Segments of a Business Enterprise. In June 1997, the FASB issued Statement No. 131, which supersedes FASB Statement No. 14. The auditing guidance contained in SAS No. 21 is inappropriate for audits of financial statements of entities that have implemented FASB Statement No. 131.

The Audit Issues Task Force of the ASB has issued an interpretation of section 326, *Evidential Matter*, entitled "Applying Auditing Procedures to Segment Disclosures in Financial Statements," to provide guidance for audits of financial statements of entities that have implemented FASB Statement No. 131. See section 9326.28–.41 for the interpretation.

AU Section 500
THE FOURTH STANDARD OF REPORTING

TABLE OF CONTENTS

AU Section 504

Association With Financial Statements

(Supersedes Statement on Auditing Standards No. 1, Sections 516, 517, and 518 and Statement on Auditing Standards No. 15, paragraphs 13–15)[1]

Source: SAS No. 26; SAS No. 35; SAS No. 72.

See section 9504 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1979.

.01 The fourth standard of reporting is:

> The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

The objective of the fourth reporting standard is to prevent misinterpretation of the degree of responsibility the accountant assumes when his name is associated with financial statements.

.02 This section defines *association* as that term is used in the fourth reporting standard. It provides guidance to an accountant associated with the financial statements of a public entity or with a nonpublic entity's financial statements that he has been engaged to audit in accordance with generally accepted auditing standards.[2]

.03 An accountant is associated with financial statements when he has consented to the use of his name in a report, document, or written communication containing the statements.[3] Also, when an accountant submits to his client or others financial statements that he has prepared or assisted in preparing, he is deemed to be associated even though the accountant does not append his name to the statements. Although the accountant may participate in the preparation of financial statements, the statements are representations of management, and the fairness of their presentation in conformity with generally accepted accounting principles is management's responsibility.

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[1] [Footnote deleted to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62.]

[2] For purposes of this section, a public entity is any entity (*a*) whose securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (*b*) that makes a filing with a regulatory agency in preparation for the sale of any class of its securities in a public market, or (*c*) a subsidiary, corporate joint venture, or other entity controlled by an entity covered by (*a*) or (*b*). Statements on Standards for Accounting and Review Services provide guidance in connection with the unaudited financial statements or other unaudited financial information of a nonpublic entity.

[3] However, this section does not apply to data, such as tax returns, prepared solely for submission to taxing authorities.

.04 An accountant may be associated with audited or unaudited financial statements. Financial statements are audited if the accountant has applied auditing procedures sufficient to permit him to report on them as described in section 508, *Reports on Audited Financial Statements*. The unaudited interim financial statements (or financial information) of a public entity are reviewed when the accountant has applied procedures sufficient to permit him to report on them as described in section 722, *Interim Financial Information*.

Disclaimer of Opinion on Unaudited Financial Statements

.05 When an accountant is associated with the financial statements of a public entity, but has not audited or reviewed[4] such statements, the form of report to be issued is as follows:

> The accompanying balance sheet of X Company as of December 31, 19X1, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.
>
> (Signature and date)

This disclaimer of opinion is the means by which the accountant complies with the fourth standard of reporting when associated with unaudited financial statements in these circumstances. The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited. When an accountant issues this form of disclaimer of opinion, he has no responsibility to apply any procedures beyond reading the financial statements for obvious material misstatements. Any procedures that may have been applied should not be described, except in the limited circumstances set forth in paragraphs .18–.20. Describing procedures that may have been applied might cause the reader to believe the financial statements have been audited or reviewed.

.06 If the accountant is aware that his name is to be included in a client-prepared written communication of a public entity containing financial statements that have not been audited or reviewed, he should request (*a*) that his name not be included in the communication or (*b*) that the financial statements be marked as unaudited and that there be a notation that he does not express an opinion on them. If the client does not comply, the accountant should advise the client that he has not consented to the use of his name and should consider what other actions might be appropriate.[5]

Disclaimer of Opinion on Unaudited Financial Statements Prepared on a Comprehensive Basis of Accounting

.07 When an accountant is associated with unaudited financial statements of a public entity prepared in accordance with a comprehensive basis

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[4] When a public entity does not have its annual financial statements audited, an accountant may be requested to review its annual or interim financial statements. In those circumstances, an accountant may make a review and look to the guidance in Statements on Standards for Accounting and Review Services for the standards and procedures and form of report applicable to such an engagement.

[5] In considering what actions, if any, may be appropriate in the circumstances, the accountant may wish to consult his legal counsel.

of accounting other than generally accepted accounting principles, he should follow the guidance provided by paragraph .05, except that he should modify the identification of financial statements in his disclaimer of opinion (see section 623.02–.10, *Special Reports*).[6] For example, a disclaimer of opinion on cash-basis statements might be worded as follows:

> The accompanying statement of assets and liabilities resulting from cash transactions of XYZ Corporation as of December 31, 19X1, and the related statement of revenues collected and expenses paid during the year then ended were not audited by us and, accordingly, we do not express an opinion on them.
>
> (Signature and date)

A note to the financial statements should describe how the basis of presentation differs from generally accepted accounting principles, but the monetary effect of such differences need not be stated.

Disclaimer of Opinion When Not Independent

.08 The second general standard requires that "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors." The independent public accountant must be without bias with respect to the client; otherwise, he would lack that impartiality necessary for the dependability of his findings. Whether the accountant is independent is something he must decide as a matter of professional judgment.

.09 When an accountant is not independent, any procedures he might perform would not be in accordance with generally accepted auditing standards, and he would be precluded from expressing an opinion on such statements. Accordingly, he should disclaim an opinion with respect to the financial statements and should state specifically that he is not independent.

.10 If the financial statements are those of a nonpublic entity, the accountant should look to the guidance in Statements on Standards for Accounting and Review Services. In all other circumstances, regardless of the extent of procedures applied, the accountant should follow the guidance in paragraph .05, except that the disclaimer of opinion should be modified to state specifically that he is not independent. The reasons for lack of independence and any procedures he has performed should not be described; including such matters might confuse the reader concerning the importance of the impairment of independence. An example of such a report is as follows:

> We are not independent with respect to XYZ Company, and the accompanying balance sheet as of December 31, 19X1, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.
>
> (Signature and date)

Circumstances Requiring a Modified Disclaimer

.11 If the accountant concludes on the basis of facts known to him that the unaudited financial statements on which he is disclaiming an opinion are not in conformity with generally accepted accounting principles, which include adequate disclosure, he should suggest appropriate revision; failing that, he should describe the departure in his disclaimer of opinion. This description should refer specifically to the nature of the departure and, if practicable, state

[6] Reference to generally accepted accounting principles in this section includes, where applicable, another comprehensive basis of accounting.

the effects on the financial statements or include the necessary information for adequate disclosure.

.12 When the effects of the departure on the financial statements are not reasonably determinable, the disclaimer of opinion should so state. When a departure from generally accepted accounting principles involves inadequate disclosure, it may not be practicable for the accountant to include the omitted disclosures in his report. For example, when management has elected to omit substantially all of the disclosures, the accountant should clearly indicate that in his report, but the accountant would not be expected to include such disclosures in his report.

.13 If the client will not agree to revision of the financial statements or will not accept the accountant's disclaimer of opinion with the description of the departure from generally accepted accounting principles, the accountant should refuse to be associated with the statements and, if necessary, withdraw from the engagement.

Reporting on Audited and Unaudited Financial Statements in Comparative Form

.14 When unaudited financial statements are presented in comparative form with audited financial statements in documents filed with the Securities and Exchange Commission, such statements should be clearly marked as "unaudited" but should not be referred to in the auditor's report.

.15 When unaudited financial statements are presented in comparative form with audited financial statements in any other document, the financial statements that have not been audited should be clearly marked to indicate their status and either (*a*) the report on the prior period should be reissued (see section 530.06–.08)[7] or (*b*) the report on the current period should include as a separate paragraph an appropriate description of the responsibility assumed for the financial statements of the prior period (see paragraphs .16 and .17). Either reissuance or reference in a separate paragraph is acceptable; in both circumstances, the accountant should consider the current form and manner of presentation of the financial statements of the prior period in light of the information of which he has become aware during his current engagement.

.16 When the financial statements of the prior period have been audited and the report on the current period is to contain a separate paragraph, it should indicate (*a*) that the financial statements of the prior period were audited previously, (*b*) the date of the previous report, (*c*) the type of opinion expressed previously, (*d*) if the opinion was other than unqualified, the substantive reasons therefor, and (*e*) that no auditing procedures were performed after the date of the previous report. An example of such a separate paragraph is as follows:

> The financial statements for the year ended December 31, 19X1, were audited by us (other accountants) and we (they) expressed an unqualified opinion on them in our (their) report dated March 1, 19X2, but we (they) have not performed any auditing procedures since that date.

.17 When the financial statements of the prior period have not been audited and the report on the current period is to contain a separate paragraph, it should include (*a*) a statement of the service performed in the prior period,

[7] For reissuance of a compilation or review report, see Statements on Standards for Accounting and Review Services.

(*b*) the date of the report on that service, (*c*) a description of any material modifications noted in that report, and (*d*) a statement that the service was less in scope than an audit and does not provide the basis for the expression of an opinion on the financial statements taken as a whole. When the financial statements are those of a public entity, the separate paragraph should include a disclaimer of opinion (see paragraph .05) or a description of a review. When the financial statements are those of a nonpublic entity and the financial statements were compiled or reviewed, the separate paragraph should contain an appropriate description of the compilation or review. For example, a separate paragraph describing a review might be worded as follows:

> The 20X1 financial statements were reviewed by us (other accountants) and our (their) report thereon, dated March 1, 20X2, stated we (they) were not aware of any material modifications that should be made to those statements for them to be in conformity with generally accepted accounting principles. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements taken as a whole.

A separate paragraph describing a compilation might be worded as follows:

> The 19X1 financial statements were compiled by us (other accountants) and our (their) report thereon, dated March 1, 19X2, stated we (they) did not audit or review those financial statements and, accordingly, express no opinion or other form of assurance on them.

Negative Assurance

.18 When an accountant, for whatever reason, disclaims an opinion on financial statements his disclaimer should not be contradicted by the inclusion of expressions of assurance on the absence of knowledge of departures from generally accepted accounting principles except as specifically recognized as appropriate in applicable standards established by the American Institute of Certified Public Accountants.

.19 Negative assurances, for example, are permissible in letters for underwriters in which the independent auditor reports on limited procedures followed with respect to unaudited financial statements or other financial data pertinent to a registration statement filed with the Securities and Exchange Commission (see section 634, *Letters for Underwriters and Certain Other Requesting Parties*[*]).

[.20] [Superseded, February 1993, by Statement on Auditing Standards No. 72.] (See section 634.)

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[*] [Section 631, formerly 630, changed by the issuance of Statement on Auditing Standards No. 38 (superseded). Section 634, formerly 631, changed by the issuance of Statement on Auditing Standards No. 49 (superseded). Title of section 634 changed, February 1993, to reflect the issuance of Statement on Auditing Standards No. 72.] (See section 634.)

AU Section 9504

Association With Financial Statements: Auditing Interpretations of Section 504

1. Annual Report Disclosure of Unaudited Fourth Quarter Interim Data

.01 *Question*—APB Opinion No. 28, paragraph 31 [AC section I73.147], which applies to publicly traded companies, states: "If interim financial data and disclosures are not separately reported for the fourth quarter, security holders often make inferences about that quarter by subtracting data based on the third quarter interim report from the annual results. In the absence of a separate fourth quarter report or disclosure of the results . . . for that quarter in the annual report, disposals of segments of a business and extraordinary, unusual, or infrequently occurring items recognized in the fourth quarter, as well as the aggregate effect of year-end adjustments which are material to the results of that quarter . . . shall be disclosed in the annual report in a note to the annual financial statements." Does the auditor have an obligation, arising from the disclosure requirements of paragraph 31 of Opinion No. 28 [AC section I73.147], to audit interim data?

.02 *Interpretation*—No. If the auditor has not been specifically engaged to audit interim information, he does not have an obligation to audit interim data as a result of his audit of the annual financial statements.

.03 Disclosure of fourth quarter adjustments and other disclosures required by paragraph 31 [AC section I73.147] would appear in a note to the annual financial statements of a publicly traded company only if fourth quarter data were not separately distributed or did not appear elsewhere in the annual report. Consequently, such disclosures are not essential for a fair presentation of the annual financial statements in conformity with generally accepted accounting principles.

.04 If interim financial data and disclosures are not separately reported (as outlined in paragraph 30 of Opinion No. 28 [AC section I73.146]) for the fourth quarter, the independent auditor, during his audit of the annual financial statements, should inquire as to whether there are fourth quarter items that need to be disclosed in a note to the annual financial statements.

.05 Information on fourth quarter adjustments and similar items that appear in notes to the annual financial statements to comply with paragraph 31 of Opinion No. 28 [AC section I73.147] would ordinarily not be audited separately and, therefore, the information would be labeled "unaudited" or "not covered by auditor's report."

.06 If a publicly traded company fails to comply with the provisions of paragraph 31 of Opinion No. 28 [AC section I73.147], the auditor should suggest appropriate revision; failing that, he should call attention in his report to the omission of the information. The auditor need not qualify his opinion on the annual financial statements since the disclosure is not essential for a fair presentation of those statements in conformity with generally accepted accounting principles.

.07 Reference should be made to section 722 for guidance with respect to reviews of interim financial information of SEC registrants or non-SEC registrants that make a filing with a regulatory agency in preparation for a public offering or listing.

[Issue Date: November, 1979; Revised: November, 2002.]

[2.] Association of the Auditor of an Acquired Company With Unaudited Statements in a Listing Application

[.08–.12] [Deleted May, 1980.]

[3.] Association of the Auditor of the Acquiring Company With Unaudited Statements in a Listing Application

[.13–.14] [Deleted May, 1980.]

4. Auditor's Identification With Condensed Financial Data

.15 *Question*—Section 150.02 states in part: "In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking." Section 504.03 states that "An accountant is associated with financial statements when he has consented to the use of his name in a report, document, or written communication containing the statements." Is the auditor "associated" with condensed financial data when he is identified by a financial reporting service as being a company's independent auditor or when his report is reproduced and presented with such data?

.16 *Interpretation*—No. The accountant has not consented to the use of his name when it is published by a financial reporting service. Financial data released to the public by a company and the name of its auditor are public information. Accordingly, neither the auditor nor his client has the ability to require a financial reporting service to withhold publishing such information.

.17 Financial reporting services, such as Dun & Bradstreet and Moody's Investors Service, furnish to subscribers information and ratings concerning commercial enterprises as a basis for credit, insurance, marketing and other business purposes. Those reports frequently include condensed financial data and other data such as payments to trade creditors, loan experience with banks, a brief history of the entity and a description of its operations. Also, as part of its report, the financial service often discloses the names of the officers and directors or principals or owners of the company and the name of the company's auditor.

.18 In the context in which the auditor's name appears, it is doubtful that readers will assume that he has audited the information presented. However, the AICPA has suggested to certain financial reporting services that they identify data as "unaudited" if the data has been extracted from unaudited financial statements. Also, the AICPA has suggested that when summarized financial data is presented together with an auditor's report on complete financial statements (including notes), the financial reporting services state that the auditor's report applies to the complete financial statements which are not presented.

[Issue Date: November, 1979.]

5. Applicability of Guidance on Reporting When Not Independent

.19 *Question*—Section 504 describes the reporting responsibilities of the certified public accountant who has determined that he is not independent with respect to financial statements with which he is associated. That section, however, does not indicate how he should determine whether he is independent. What should the certified public accountant consider in determining whether he is independent? Also, should his consideration be any different for an engagement to prepare unaudited financial statements?

.20 *Interpretation*—Section 504 explains the certified public accountant's reporting responsibilities when he is not independent. However, it does not attempt to explain how the certified public accountant determines whether he is independent because that is a question of professional ethics. Section 220.04 states: "The profession has established, through the AICPA Code of Professional Conduct, precepts to guard against the . . . loss of independence." The AICPA, state CPA societies and state boards of accountancy have issued pronouncements to provide the certified public accountant with guidance to aid him in determining whether he is independent.

.21 The certified public accountant should consider the AICPA's Code of Professional Conduct in determining whether he is independent and whether the reporting requirements of section 504 apply. He should also consider the ethical requirements of his state CPA society or state board of accountancy.

.22 Section 504.10 states that the reporting guidance applies, *regardless of the extent of procedures applied*, (emphasis added) in all circumstances other than when the financial statements are those of a non-public entity.[1] Thus, the accountant's consideration of whether he is independent should be the same whether the financial statements are audited or unaudited.

[Issue Date: November, 1979.]

[6.] Reporting on Solvency

[.23–.35] [Rescinded May, 1988 by the issuance of attestation interpretation, "Responding to Requests for Reports on Matters Relating to Solvency."] (See AT section 9101.23–.33.) [Revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

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[1] If the financial statements are those of a non-public entity, the accountant should look to the guidance in Statements on Standards for Accounting and Review Services.

AU Section 508*

Reports on Audited Financial Statements

(Supersedes sections 505, 509, 542, 545, and 546)

Source: SAS No. 58; SAS No. 64; SAS No. 79; SAS No. 85; SAS No. 93; SAS No. 98; Auditing Standard No. 5; Auditing Standard No. 6; Auditing Standard Nos. 8–15.

See section 9508 for interpretations of this section.

Effective for reports issued or reissued on or after January 1, 1989, unless otherwise indicated.

Introduction

.01 This section applies to auditors' reports issued in connection with audits[1] of historical financial statements that are intended to present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. It distinguishes the types of reports, describes the circumstances in which each is appropriate, and provides example reports.

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]

> Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs 85–98 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and Appendix C, *Special Reporting Situations*, of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, for direction on reporting on internal control over financial reporting. In addition, see paragraphs 86–88 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, which includes an illustrative combined audit report.

.02 This section does not apply to unaudited financial statements as described in section 504, *Association With Financial Statements*, nor does it apply to reports on incomplete financial information or other special presentations as described in section 623, *Special Reports*.

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* This section has been revised to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.

[1] An audit, for purposes of this section, is defined as an examination of historical financial statements performed in accordance with generally accepted auditing standards in effect at the time the audit is performed. Generally accepted auditing standards include the ten standards as well as the Statements on Auditing Standards that interpret those standards. In some cases, regulatory authorities may have additional requirements applicable to entities under their jurisdiction and auditors of such entities should consider those requirements.

.03 *[The following paragraph is effective November 15, 2008. See PCAOB Release 2008-001.]*

Justification for the expression of the auditor's opinion rests on the conformity of his or her audit with generally accepted auditing standards and on the findings. Generally accepted auditing standards include four standards of reporting.[2] This section is concerned primarily with the relationship of the fourth reporting standard to the language of the auditor's report.

.04 The fourth standard of reporting is as follows:

> The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

.05 The objective of the fourth standard is to prevent misinterpretation of the degree of responsibility the auditor is assuming when his or her name is associated with financial statements. Reference in the fourth reporting standard to the financial statements "taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement (for example, to a balance sheet) for one or more periods presented. (Paragraph .65 discusses the fourth standard of reporting as it applies to comparative financial statements.) The auditor may express an unqualified opinion on one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances warrant.

.06 The auditor's report is customarily issued in connection with an entity's basic financial statements—balance sheet, statement of income, statement of retained earnings and statement of cash flows. Each financial statement audited should be specifically identified in the introductory paragraph of the auditor's report. If the basic financial statements include a separate statement of changes in stockholders' equity accounts, it should be identified in the introductory paragraph of the report but need not be reported on separately in the opinion paragraph since such changes are part of the presentation of financial position, results of operations, and cash flows.

The Auditor's Standard Report

.07 The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards.

.08 The auditor's standard report identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion in a separate opinion paragraph. The basic elements of the report are the following:

a. A title that includes the word *independent*[3]

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[2] *[Footnote deleted, effective November 15, 2008. See PCAOB Release 2008-001.]*

[3] This section does not require a title for an auditor's report if the auditor is not independent. See section 504, *Association With Financial Statements*, for guidance on reporting when the auditor is not independent.

b. A statement that the financial statements identified in the report were audited

c. A statement that the financial statements are the responsibility of the Company's management[4] and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit

d. A statement that the audit was conducted in accordance with generally accepted auditing standards and an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards)

e. A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement

f. A statement that an audit includes—

(1) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements

(2) Assessing the accounting principles used and significant estimates made by management

(3) Evaluating the overall financial statement presentation[5]

g. A statement that the auditor believes that his or her audit provides a reasonable basis for his or her opinion

h. An opinion as to whether the financial statements present fairly, in all material respects, the financial position of the Company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with generally accepted accounting principles. The opinion should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles[6])

i. The manual or printed signature of the auditor's firm

j. The date[7] of the audit report

The form of the auditor's standard report on financial statements covering a single year is as follows:

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[4] In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility.

[5] Section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, paragraphs .03 and .04, discuss the auditor's evaluation of the overall presentation of the financial statements. [As amended, effective for reports issued or reissued on or after June 30, 2001, by Statement on Auditing Standards No. 93.]

[6] A U.S. auditor also may be engaged to report on the financial statements of a U.S. entity that have been prepared in conformity with accounting principles generally accepted in another country. In those circumstances, the auditor should refer to the guidance in section 534, *Reporting on Financial Statements Prepared for Use in Other Countries.* [Footnote added, effective for reports issued or reissued on or after June 30, 2001 by Statement on Auditing Standards No. 93.]

[7] For guidance on dating the auditor's report, see section 530, *Dating of the Independent Auditor's Report*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

The form of the auditor's standard report on comparative financial statements[8] is as follows:

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[8] If statements of income, retained earnings, and cash flows are presented on a comparative basis for one or more prior periods, but the balance sheet(s) as of the end of one (or more) of the prior period(s) is not presented, the phrase "for the years then ended" should be changed to indicate that the auditor's opinion applies to each period for which statements of income, retained earnings, and cash flows are presented, such as "for each of the three years in the period ended [date of latest balance sheet]." [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

k. When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements:

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of X Company's internal control over financial reporting as of December 31, 20X3, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed *[include nature of opinions*].

.09 The report may be addressed to the company whose financial statements are being audited or to its board of directors or stockholders. A report on the financial statements of an unincorporated entity should be addressed as circumstances dictate, for example, to the partners, to the general partner, or to the proprietor. Occasionally, an auditor is retained to audit the financial statements of a company that is not a client; in such a case, the report is customarily addressed to the client and not to the directors or stockholders of the company whose financial statements are being audited.

.10 This section also discusses the circumstances that may require the auditor to depart from the standard report and provides reporting guidance in such circumstances. This section is organized by type of opinion that the auditor may express in each of the various circumstances presented; this section describes what is meant by the various audit opinions:

- *Unqualified opinion*. An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles. This is the opinion expressed in the standard report discussed in paragraph .08.
- *Explanatory language added to the auditor's standard report*. Certain circumstances, while not affecting the auditor's unqualified opinion on the financial statements, may require that the auditor add an explanatory paragraph (or other explanatory language) to his or her report.
- *Qualified opinion*. A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles.
- *Adverse opinion*. An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with generally accepted accounting principles.
- *Disclaimer of opinion.* A disclaimer of opinion states that the auditor does not express an opinion on the financial statements.

These opinions are discussed in greater detail throughout the remainder of this section.

Explanatory Language Added to the Auditor's Standard Report

.11 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add an explanatory [9] paragraph (or other explanatory language) to the standard report. [10] These circumstances include:

a. The auditor's opinion is based in part on the report of another auditor (paragraphs .12 and .13).

[Items .11b, c, and d are effective November 15, 2008. See PCAOB Release 2008-001.]

b. There is substantial doubt about the entity's ability to continue as a going concern.[11]

c. There has been a material change between periods in accounting principles or in the method of their application (paragraphs .17A through .17E).

d. A material misstatement in previously issued financial statements has been corrected (paragraphs .18A through .18C).

e. Certain circumstances relating to reports on comparative financial statements exist (paragraphs .68, .69, and .72 through .74).

f. Selected quarterly financial data required by SEC Regulation S-K has been omitted or has not been reviewed. (See section 722, *Interim Financial Information*, paragraph .50.)

g. Supplementary information required by the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB), or the Federal Accounting Standards Advisory Board (FASAB) has been omitted, the presentation of such information departs materially from FASB, GASB, or FASAB guidelines, the auditor is unable to complete prescribed procedures with respect to such information, or the auditor is unable to remove substantial doubts about whether the supplementary information conforms to FASB, GASB, or FASAB guidelines. (See section 558, *Required Supplementary Information*, paragraph .02.)

h. Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements. (See section 550, *Other Information in Documents Containing Audited Financial Statements*, paragraph .04.)

In addition, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (paragraph .19). [As amended, effective for reports issued or reissued on or after February 29, 1996, by Statement

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[9] Unless otherwise required by the provisions of this section, an explanatory paragraph may precede or follow the opinion paragraph in the auditor's report. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

[10] See footnote 3. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

[11] Section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, describes the auditor's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and, when applicable, to consider the adequacy of financial statement disclosure and to include an explanatory paragraph in the report to reflect his or her conclusions. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

on Auditing Standards No. 79. Revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 100.]

Opinion Based in Part on Report of Another Auditor

.12 When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, he or she should disclose this fact in the introductory paragraph of his or her report and should refer to the report of the other auditor in expressing his or her opinion. These references indicate division of responsibility for performance of the audit. (See section 543, *Part of Audit Performed by Other Independent Auditors*.)

.13 An example of a report indicating a division of responsibility follows:

Independent Auditor's Report

We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of $_____ and $_____ as of December 31, 20X2 and 20X1, respectively, and total revenues of $_____ and $_____ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[.14–.15] *[Paragraphs .14 and .15 deleted, effective November 15, 2008. See PCAOB Release 2008-001.]*

Former paragraphs .16 through .33 and related footnotes have been deleted and all subsequent paragraphs and footnotes renumbered by the issuance of Statement on Auditing Standards No. 79, effective for reports issued or reissued on or after February 29, 1996.

Lack of Consistency

.16 *[The following paragraph is effective November 15, 2008. See PCAOB Release 2008-001.]*

The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:

a. A change in accounting principle.

b. An adjustment to correct a misstatement in previously issued financial statements.

Change in Accounting Principle

[Paragraphs 17A through 17C are effective November 15, 2008. See PCAOB Release 2008-001.]

.17A As discussed in PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, the auditor should evaluate a change in accounting principle to determine whether (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, (3) the disclosures related to the accounting change are adequate, and (4) the company has justified that the alternative accounting principle is preferable.[12] A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the opinion paragraph. If the auditor concludes that the criteria in this paragraph have been met, the explanatory paragraph in the auditor's report should include identification of the nature of the change and a reference to the note disclosure describing the change.

.17B Following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:

> As discussed in Note X to the financial statements, the company has changed its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].

.17C Following is an example of an explanatory paragraph when the company has made a change in accounting principle other than a change due to the adoption of a new accounting pronouncement.

> As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*].

.17D The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied

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[12] The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. See FASB Statement 154, paragraph 14.

in all periods presented. If the accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.

.17E If the auditor concludes that the criteria in paragraph .17A for a change in accounting principle are not met, the auditor should consider the matter to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or adverse opinion.

Correction of a Material Misstatement in Previously Issued Financial Statements

[Paragraphs 18A through 18C are effective November 15, 2008. See PCAOB Release 2008-001.]

.18A Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.[13] The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. Following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements.

> As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.

.18B This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.

.18C *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The accounting pronouncements generally require certain disclosures relating to restatements to correct a misstatement in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the lack of disclosure as discussed beginning at paragraph .41.

Emphasis of a Matter

.19 In any report on financial statements, the auditor may emphasize a matter regarding the financial statements. Such explanatory information should be presented in a separate paragraph of the auditor's report. Phrases such as "with the foregoing [following] explanation" should not be used in the opinion paragraph if an emphasis paragraph is included in the auditor's report. Emphasis paragraphs are never required; they may be added solely at the auditor's discretion. Examples of matters the auditor may wish to emphasize are—

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[13] The directions in paragraphs .68-.69 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.

- That the entity is a component of a larger business enterprise.
- That the entity has had significant transactions with related parties.
- Unusually important subsequent events.
- Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period.

[Paragraph renumbered and amended, effective for reports issued or reissued on or after February 29, 1996, by the issuance of Statement on Auditing Standards No. 79.]

Departures From Unqualified Opinions

Qualified Opinions

.20 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Certain circumstances may require a qualified opinion. A qualified opinion states that, *except for* the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. Such an opinion is expressed when—

a. There is a lack of sufficient appropriate evidential matter or there are restrictions on the scope of the audit that have led the auditor to conclude that he or she cannot express an unqualified opinion and he or she has concluded not to disclaim an opinion (paragraphs .22–.34).

b. The auditor believes, on the basis of his or her audit, that the financial statements contain a departure from generally accepted accounting principles, the effect of which is material, and he or she has concluded not to express an adverse opinion (paragraphs .35–.57).

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.21 When the auditor expresses a qualified opinion, he or she should disclose all of the substantive reasons in one or more separate explanatory paragraph(s) preceding the opinion paragraph of the report. The auditor should also include, in the opinion paragraph, the appropriate qualifying language and a reference to the explanatory paragraph. A qualified opinion should include the word *except* or *exception* in a phrase such as *except for* or *with the exception of*. Phrases such as *subject to* and *with the foregoing explanation* are not clear or forceful enough and should not be used. Since accompanying notes are part of the financial statements, wording such as *fairly presented, in all material respects, when read in conjunction with Note 1* is likely to be misunderstood and should not be used. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

Scope Limitations

.22 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor can determine that he or she is able to express an unqualified opinion only if the audit has been conducted in accordance with generally accepted

auditing standards and if he or she has therefore been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of the audit, whether imposed by the client or by circumstances, such as the timing of his or her work, the inability to obtain sufficient appropriate evidential matter, or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in the report. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.23 The auditor's decision to qualify his or her opinion or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on the financial statements being audited. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to the financial statements. If the potential effects relate to many financial statement items, this significance is likely to be greater than if only a limited number of items is involved. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.24 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors. [14] Another common scope restriction involves accounting for long-term investments when the auditor has not been able to obtain audited financial statements of an investee. Restrictions on the application of these or other audit procedures to important elements of the financial statements require the auditor to decide whether he or she has examined sufficient appropriate evidential matter to permit him or her to express an unqualified or qualified opinion, or whether he or she should disclaim an opinion. When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.25 When a qualified opinion results from a limitation on the scope of the audit or an insufficiency of evidential matter, the situation should be described in an explanatory paragraph preceding the opinion paragraph and referred to in both the scope and opinion paragraphs of the auditor's report. It is not appropriate for the scope of the audit to be explained in a note to the financial statements, since the description of the audit scope is the responsibility of the auditor and not that of the client. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.26 When an auditor qualifies his or her opinion because of a scope limitation, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the

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[14] Circumstances such as the timing of the work may make it impossible for the auditor to accomplish these procedures. In this case, if the auditor is able to satisfy himself or herself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of the work, and the report need not include a reference to the omission of the procedures or the use of alternative procedures. It is important to understand, however, that section 331, *Inventories*, states that "it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions." [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

scope limitation itself. Wording such as "In our opinion, except for the above-mentioned limitation on the scope of our audit . . ." bases the exception on the restriction itself, rather than on the possible effects on the financial statements and, therefore, is unacceptable. An example of a qualified opinion related to a scope limitation concerning an investment in a foreign affiliate (assuming the effects of the limitation are such that the auditor has concluded that a disclaimer of opinion is not appropriate) follows:

Independent Auditor's Report

[*Same first paragraph as the standard report*]

Except as discussed in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $_____ and $_____ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of $_____ and $_____, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.27 ***Other scope limitations.*** Sometimes, notes to financial statements may contain unaudited information, such as pro forma calculations or other similar disclosures. If the unaudited information (for example, an investor's share, material in amount, of an investee's earnings recognized on the equity method) is such that it should be subjected to auditing procedures in order for the auditor to form an opinion with respect to the financial statements taken as a whole, the auditor should apply the procedures he or she deems necessary to the unaudited information. If the auditor has not been able to apply the procedures he or she considers necessary, the auditor should qualify his or her opinion or disclaim an opinion because of a limitation on the scope of the audit. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.28 If, however, these disclosures are not necessary to fairly present the financial position, operating results, or cash flows on which the auditor is reporting, such disclosures may be identified as *unaudited* or as *not covered by the auditor's report*. For example, the pro forma effects of a business combination or of a subsequent event may be labelled unaudited. Therefore, while the event or

transaction giving rise to the disclosures in these circumstances should be audited, the pro forma disclosures of that event or transaction would not be. The auditor should be aware, however, that section 530, *Dating of the Independent Auditor's Report*, states that, if the auditor is aware of a material subsequent event that has occurred after the completion of fieldwork but before issuance of the report that should be disclosed, the auditor's only options are to dual date the report or date the report as of the date of the subsequent event and extend the procedures for review of subsequent events to that date. Labelling the note unaudited is not an acceptable alternative in these circumstances. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.29 ***Uncertainties and scope limitations.*** A matter involving an uncertainty is one that is expected to be resolved at a future date, at which time conclusive evidential matter concerning its outcome would be expected to become available. Uncertainties include, but are not limited to, contingencies covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and matters related to estimates covered by Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.30 Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with generally accepted accounting principles, based on management's analysis of existing conditions. An audit includes an assessment of whether the evidential matter is sufficient to support management's analysis. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate. [Paragraph added, effective for reports issued or reissued on or after February 29, 1996, by Statement on Auditing Standards No. 79.]

.31 If the auditor is unable to obtain sufficient evidential matter to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. A qualification or disclaimer of opinion because of a scope limitation is appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management. [Paragraph added, effective for reports issued or reissued on or after February 29, 1996, by Statement on Auditing Standards No. 79.]

.32 Scope limitations related to uncertainties should be differentiated from situations in which the auditor concludes that the financial statements are materially misstated due to departures from generally accepted accounting principles related to uncertainties. Such departures may be caused by inadequate disclosure concerning the uncertainty, the use of inappropriate accounting

principles, or the use of unreasonable accounting estimates. Paragraphs .45 to .49 provide guidance to the auditor when financial statements contain departures from generally accepted accounting principles related to uncertainties. [Paragraph added, effective for reports issued or reissued on or after February 29, 1996, by Statement on Auditing Standards No. 79.]

.33 ***Limited reporting engagements.*** The auditor may be asked to report on one basic financial statement and not on the others. For example, he or she may be asked to report on the balance sheet and not on the statements of income, retained earnings or cash flows. These engagements do not involve scope limitations if the auditor's access to information underlying the basic financial statements is not limited and if the auditor applies all the procedures he considers necessary in the circumstances; rather, such engagements involve limited reporting objectives. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.34 An auditor may be asked to report on the balance sheet only. In this case, the auditor may express an opinion on the balance sheet only. An example of an unqualified opinion on a balance-sheet-only audit follows (the report assumes that the auditor has been able to satisfy himself or herself regarding the consistency of application of accounting principles):

Independent Auditor's Report

> We have audited the accompanying balance sheet of X Company as of December 31, 20XX. This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.
>
> We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the balance sheet is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the balance sheet. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall balance sheet presentation. We believe that our audit of the balance sheet provides a reasonable basis for our opinion.
>
> In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

Departure From a Generally Accepted Accounting Principle

.35 When financial statements are materially affected by a departure from generally accepted accounting principles and the auditor has audited the statements in accordance with generally accepted auditing standards, he or she should express a qualified (paragraphs .36 through .57) or an adverse (paragraphs .58 through .60) opinion. The basis for such opinion should be stated in the report. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.36 In deciding whether the effects of a departure from generally accepted accounting principles are sufficiently material to require either a qualified or adverse opinion, one factor to be considered is the dollar magnitude of such effects. However, the concept of materiality does not depend entirely on relative

size; it involves qualitative as well as quantitative judgments. The significance of an item to a particular entity (for example, inventories to a manufacturing company), the pervasiveness of the misstatement (such as whether it affects the amounts and presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole are all factors to be considered in making a judgment regarding materiality. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.37 When the auditor expresses a qualified opinion, he or she should disclose, in a separate explanatory paragraph(s) preceding the opinion paragraph of the report, all of the substantive reasons that have led him or her to conclude that there has been a departure from generally accepted accounting principles. Furthermore, the opinion paragraph of the report should include the appropriate qualifying language and a reference to the explanatory paragraph(s). [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.38 The explanatory paragraph(s) should also disclose the principal effects of the subject matter of the qualification on financial position, results of operations, and cash flows, if practicable.[15] If the effects are not reasonably determinable, the report should so state. If such disclosures are made in a note to the financial statements, the explanatory paragraph(s) may be shortened by referring to it. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.39 An example of a report in which the opinion is qualified because of the use of an accounting principle at variance with generally accepted accounting principles follows (assuming the effects are such that the auditor has concluded that an adverse opinion is not appropriate):

Independent Auditor's Report

[*Same first and second paragraphs as the standard report*]

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_____ and $_____, long-term debt by $_____ and $_____, and retained earnings by $_____ and $_____ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by $_____ and $_____ and earnings per share would be increased (decreased) by $_____ and $_____, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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[15] 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. For example, if the information can be obtained from the accounts and records without the auditor substantially increasing the effort that would normally be required to complete the audit, the information should be presented in the report. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.40 If the pertinent facts are disclosed in a note to the financial statements, a separate paragraph (preceding the opinion paragraph) of the auditor's report in the circumstances illustrated in paragraph .39 might read as follows:

> As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheets. In our opinion, accounting principles generally accepted in the United States of America require that such obligations be included in the balance sheets.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.41 ***Inadequate disclosure.*** Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include the related notes). When such information is set forth elsewhere in a report to shareholders, or in a prospectus, proxy statement, or other similar report, it should be referred to in the financial statements. If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express a qualified or adverse opinion because of the departure from those principles and should provide the information in the report, if practicable,[16] unless its omission from the auditor's report is recognized as appropriate by a specific Statement on Auditing Standards. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.42 Following is an example of a report qualified for inadequate disclosure (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate):

> Independent Auditor's Report
>
> [*Same first and second paragraphs as the standard report*]
>
> The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.
>
> In our opinion, except for the omission of the information discussed in the preceding paragraph, . . .

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.43 If a company issues financial statements that purport to present financial position and results of operations but omits the related statement of cash flows, the auditor will normally conclude that the omission requires qualification of his opinion. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.44 The auditor is not required to prepare a basic financial statement (for example, a statement of cash flows for one or more periods) and include it in the report if the company's management declines to present the statement.

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[16] See footnote 15. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

Accordingly, in these cases, the auditor should ordinarily qualify the report in the following manner:

Independent Auditor's Report

> We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income and retained earnings for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.
>
> [*Same second paragraph as the standard report*]
>
> The Company declined to present a statement of cash flows for the years ended December 31, 20X2 and 20X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by accounting principles generally accepted in the United States of America.
>
> In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.45 ***Departures from generally accepted accounting principles involving risks or uncertainties, and materiality considerations.*** Departures from generally accepted accounting principles involving risks or uncertainties generally fall into one of the following categories:

- Inadequate disclosure (paragraphs .46 and .47)
- Inappropriate accounting principles (paragraph .48)
- Unreasonable accounting estimates (paragraph .49)

[Paragraph added, effective for reports issued or reissued on or after February 29, 1996, by Statement on Auditing Standards No. 79.]

.46 If the auditor concludes that a matter involving a risk or an uncertainty is not adequately disclosed in the financial statements in conformity with generally accepted accounting principles, the auditor should express a qualified or an adverse opinion. [Paragraph added, effective for reports issued or reissued on or after February 29, 1996, by Statement on Auditing Standards No. 79.]

.47 The auditor should consider materiality in evaluating the adequacy of disclosure of matters involving risks or uncertainties in the financial statements in the context of the financial statements taken as a whole. The auditor's consideration of materiality is a matter of professional judgment and is influenced by his or her perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments involving risks or uncertainties are made in light of the surrounding circumstances. The auditor evaluates the materiality of reasonably possible losses that may be incurred upon the resolution of uncertainties both individually and in the aggregate. The auditor performs the evaluation of reasonably possible losses without regard to his or her evaluation of the materiality of known and likely misstatements in the financial statements. [Paragraph added, effective for reports issued or reissued on or after February 29, 1996, by Statement on Auditing Standards No. 79.]

.48 In preparing financial statements, management estimates the outcome of certain types of future events. For example, estimates ordinarily are made about the useful lives of depreciable assets, the collectibility of accounts receivable, the realizable value of inventory items, and the provision for product warranties. FASB Statement No. 5, *Accounting for Contingencies*, paragraphs 23 and 25, describes situations in which the inability to make a reasonable estimate may raise questions about the appropriateness of the accounting principles used. If, in those or other situations, the auditor concludes that the accounting principles used cause the financial statements to be materially misstated, he or she should express a qualified or an adverse opinion. [Paragraph added, effective for reports issued or reissued on or after February 29, 1996, by Statement on Auditing Standards No. 79.]

.49 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Usually, the auditor is able to satisfy himself or herself regarding the reasonableness of management's estimate of the effects of future events by considering various types of evidential matter, including the historical experience of the entity. If the auditor concludes that management's estimate is unreasonable (see paragraph 13 of Auditing Standard No. 14, *Evaluating Audit Results*.) and that its effect is to cause the financial statements to be materially misstated, he or she should express a qualified or an adverse opinion.

[.50] *[Paragraph deleted, effective November 15, 2008. See PCAOB Release 2008-001.]*

.51 *[The following paragraph is effective November 15, 2008. See PCAOB Release 2008-001.]*

Departures from generally accepted accounting principles related to changes in accounting principle. Paragraph .17A states the criteria for evaluating a change in accounting principle. If the auditor concludes that the criteria have not been met, he or she should consider that circumstance to be a departure from generally accepted accounting principles and, if the effect of the accounting change is material, should issue a qualified or adverse opinion.

.52 *[The following paragraph is effective November 15, 2008. See PCAOB Release 2008-001.]*

The accounting standards indicate that a company may make a change in accounting principle only if it justifies that the allowable alternative accounting principle is preferable. If the company does not provide reasonable justification that the alternative accounting principle is preferable, the auditor should consider the accounting change to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, should issue a qualified or adverse opinion. The following is an example of a report qualified because a company did not provide reasonable justification that an alternative accounting principle is preferable:

Independent Auditor's Report

[*Same first and second paragraphs as the standard report*]

As disclosed in Note X to the financial statements, the Company adopted, in 20X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with accounting principles generally accepted in the United States of America, in our opinion the Company has not provided

reasonable justification that this accounting principle is preferable as required by those principles.[17]

In our opinion, except for the change in accounting principle discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.53 Whenever an accounting change results in an auditor expressing a qualified or adverse opinion on the conformity of financial statements with generally accepted accounting principles for the year of change, the auditor should consider the possible effects of that change when reporting on the entity's financial statements for subsequent years, as discussed in paragraphs .54 through .57. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.54 If the financial statements for the year of such change are presented and reported on with a subsequent year's financial statements, the auditor's report should disclose his or her reservations with respect to the statements for the year of change. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.55 If an entity has adopted an accounting principle that is not a generally accepted accounting principle, its continued use might have a material effect on the statements of a subsequent year on which the auditor is reporting. In this situation, the independent auditor should express either a qualified opinion or an adverse opinion, depending on the materiality of the departure in relation to the statements of the subsequent year. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.56 If an entity accounts for the effect of a change prospectively when generally accepted accounting principles require restatement or the inclusion of the cumulative effect of the change in the year of change, a subsequent year's financial statements could improperly include a charge or credit that is material to those statements. This situation also requires that the auditor express a qualified or an adverse opinion. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.57 *[The following paragraph is effective November 15, 2008. See PCAOB Release 2008-001.]*

If the auditor issues a qualified or adverse opinion because the company has not justified that an allowable accounting principle adopted in an accounting change is preferable, as described in paragraph .52, the auditor should continue to express that opinion on the financial statements for the year of change as long as those financial statements are presented and reported on. However, the auditor's qualified or adverse opinion relates only to the accounting change and

[17] Because this paragraph included in the example presented contains all of the information required in an explanatory paragraph on consistency, a separate explanatory paragraph (following the opinion paragraph) as required by paragraphs .17A thorough .17E of this section is not necessary in this instance. A separate paragraph that identifies the change in accounting principle would be required if the substance of the disclosure did not fulfill the requirements outlined in these paragraphs. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

does not affect the status of a newly adopted principle as a generally accepted accounting principle. Accordingly, while expressing a qualified or adverse opinion for the year of change, the independent auditor's opinion regarding the subsequent years' statements need not express a qualified or adverse opinion on the use of the newly adopted principle in subsequent periods.

Adverse Opinions

.58 An adverse opinion states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with generally accepted accounting principles. Such an opinion is expressed when, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with generally accepted accounting principles. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.59 When the auditor expresses an adverse opinion, he or she should disclose in a separate explanatory paragraph(s) preceding the opinion paragraph of the report (*a*) all the substantive reasons for his or her adverse opinion, and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable. [18] If the effects are not reasonably determinable, the report should so state. [19] [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.60 When an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion, as shown below:

Independent Auditor's Report

[*Same first and second paragraphs as the standard report*]

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Accounting principles generally accepted in the United States of America require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.

Because of the departures from accounting principles generally accepted in the United States of America identified above, as of December 31, 20X2 and 20X1, inventories have been increased $_____ and $_____ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at $_____ and $_____ in excess of an amount based on the cost to the Company; and deferred income taxes of $_____ and $_____ have not been recorded; resulting in an increase of

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[18] See footnote 15. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No 93, October 2000.]

[19] *[The following footnote is effective November 15, 2008. See PCAOB Release 2008-001.]* When the auditor expresses an adverse opinion, he or she should also consider the need for an explanatory paragraph under the circumstances identified in paragraph .11, subsection (*b*), (*c*), (*d*), and (*e*) of this section. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

> $_____ and $_____ in retained earnings and in appraisal surplus of $_____ and $_____, respectively. For the years ended December 31, 20X2 and 20X1, cost of goods sold has been increased $_____ and $_____, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of $_____ and $_____ have not been provided, resulting in an increase in net income of $_____ and $_____, respectively.
>
> In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows for the years then ended.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

Disclaimer of Opinion

.61 A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. An auditor may decline to express an opinion whenever he or she is unable to form or has not formed an opinion as to the fairness of presentation of the financial statements in conformity with generally accepted accounting principles. If the auditor disclaims an opinion, the auditor's report should give all of the substantive reasons for the disclaimer. [Paragraph renumbered and amended, effective for reports issued or reissued on or after February 29, 1996, by the issuance of Statement on Auditing Standards No. 79.]

.62 A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statements.[20] A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his or her audit, that there are material departures from generally accepted accounting principles (see paragraphs .35 through .57). When disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer. He or she should state that the scope of the audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed nor include the paragraph describing the characteristics of an audit (that is, the scope paragraph of the auditor's standard report); to do so may tend to overshadow the disclaimer. In addition, the auditor should also disclose any other reservations he or she has regarding fair presentation in conformity with generally accepted accounting principles. [Paragraph renumbered and amended, effective for reports issued or reissued on or after February 29, 1996, by the issuance of Statement on Auditing Standards No. 79.]

.63 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

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[20] *[The following footnote is effective November 15, 2008. See PCAOB Release 2008-001.]* Section 504, *Association With Financial Statements*, paragraph .05, provides guidance to an accountant who is associated with the financial statements of a public entity, but has not audited such statements. [Footnote renumbered and amended, effective for reports issued or reissued on or after February 29, 1996, by the issuance of Statement on Auditing Standards No. 79. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000. Footnote revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Standards for Accounting and Review Services No. 9.]

An example of a report disclaiming an opinion resulting from an inability to obtain sufficient appropriate evidential matter because of the scope limitation follows:

Independent Auditor's Report

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.[21]

[*Second paragraph of standard report should be omitted*]

The Company did not make a count of its physical inventory in 20X2 or 20X1, stated in the accompanying financial statements at $_____ as of December 31, 20X2, and at $_____ as of December 31, 20X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 20X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

Piecemeal Opinions

.64 Piecemeal opinions (expressions of opinion as to certain identified items in financial statements) should not be expressed when the auditor has disclaimed an opinion or has expressed an adverse opinion on the financial statements *taken as a whole* because piecemeal opinions tend to overshadow or contradict a disclaimer of opinion or an adverse opinion. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

Reports on Comparative Financial Statements

.65 The fourth standard of reporting requires that an auditor's report contain either an expression of opinion regarding the financial statements *taken as a whole* or an assertion to the effect that an opinion cannot be expressed. Reference in the fourth reporting standard to the financial statements *taken as a whole* applies not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. Therefore, a continuing auditor[22]

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[21] The wording in the first paragraph of the auditor's standard report is changed in a disclaimer of opinion because of a scope limitation. The first sentence now states that "we were engaged to audit" rather than "we have audited" since, because of the scope limitation, the auditor was not able to perform an audit in accordance with generally accepted auditing standards. In addition, the last sentence of the first paragraph is also deleted, because of the scope limitation, to eliminate the reference to the auditor's responsibility to express an opinion. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

[22] A *continuing auditor* is one who has audited the financial statements of the current period and of one or more consecutive periods immediately prior to the current period. If one firm of independent

(continued)

should update[23] the report on the individual financial statements of the one or more prior periods presented on a comparative basis with those of the current period.[24] Ordinarily, the auditor's report on comparative financial statements should be dated as of the date of completion of fieldwork for the most recent audit. (See section 530, *Dating of the Independent Auditor's Report*, paragraph .01.) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.66 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

During the audit of the current-period financial statements, the auditor should be alert for circumstances or events that affect the prior-period financial statements presented (see paragraph .68) or the adequacy of informative disclosures concerning those statements. (See paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*.) In updating his or her report on the prior-period financial statements, the auditor should consider the effects of any such circumstances or events coming to his or her attention. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

Different Reports on Comparative Financial Statements Presented

.67 Since the auditor's report on comparative financial statements applies to the individual financial statements presented, an auditor may express a qualified or adverse opinion, disclaim an opinion, or include an explanatory paragraph with respect to one or more financial statements for one or more

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(footnote continued)

auditors merges with another firm and the new firm becomes the auditor of a former client of one of the former firms, the new firm may accept responsibility and express an opinion on the financial statements for the prior period(s), as well as for those of the current period. In such circumstances, the new firm should follow the guidance in paragraphs .65 through .69 and may indicate in its report or signature that a merger took place and may name the firm of independent auditors that was merged with it. If the new firm decides not to express an opinion on the prior-period financial statements, the guidance in paragraphs .70 through .74 should be followed. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

[23] An updated report on prior-period financial statements should be distinguished from a reissuance of a previous report (see section 530, *Dating of the Independent Auditor's Report*, paragraphs .06 through .08), since in issuing an updated report the continuing auditor considers information that he or she has become aware of during his or her audit of the current-period financial statements (see paragraph .68) and because an updated report is issued in conjunction with the auditor's report on the current-period financial statements. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

[24] A continuing auditor need not report on the prior-period financial statements if only summarized comparative information of the prior period(s) is presented. For example, entities such as state and local governmental units frequently present total-all-funds information for the prior period(s) rather than information by individual funds because of space limitations or to avoid cumbersome or confusing formats. Also, not-for-profit organizations frequently present certain information for the prior period(s) in total rather than by net asset class. In some circumstances, the client may request the auditor to express an opinion on the prior period(s) as well as the current period. In those circumstances, the auditor should consider whether the information included for the prior period(s) contains sufficient detail to constitute a fair presentation in conformity with generally accepted accounting principles. In most cases, this will necessitate including additional columns or separate detail by fund or net asset class, or the auditor would need to modify his or her report. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000. Revised, April 2002, to reflect conforming changes necessary due to the issuance of FASB Statement No. 117.]

periods, while issuing a different report on the other financial statements presented. Following are examples of reports on comparative financial statements (excluding the standard introductory and scope paragraphs, where applicable) with different reports on one or more financial statements presented.

Standard Report on the Prior-Year Financial Statements and a Qualified Opinion on the Current-Year Financial Statements

Independent Auditor's Report

[*Same first and second paragraphs as the standard report*]

The Company has excluded, from property and debt in the accompanying 20X2 balance sheet, certain lease obligations that were entered into in 20X2 which, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_____, long-term debt by $_____, and retained earnings by $_____as of December 31, 20X2, and net income and earnings per share would be increased (decreased) by $_____ and $_____, respectively, for the year then ended.

In our opinion, except for the effects on the 20X2 financial statements of not capitalizing certain lease obligations as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Standard Report on the Current-Year Financial Statements With a Disclaimer of Opinion on the Prior-Year Statements of Income, Retained Earnings, and Cash Flows

Independent Auditor's Report

[*Same first paragraph as the standard report*]

Except as explained in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We did not observe the taking of the physical inventory as of December 31, 20X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 20X0, enter into the determination of net income and cash flows for the year ended December 31, 20X1.[25]

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[25] *[The following footnote is effective November 15, 2008. See PCAOB Release 2008-001.]* It is assumed that the independent auditor has been able to satisfy himself or herself as to the consistency

(continued)

> Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 20X1.
>
> In our opinion, the balance sheets of ABC Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 20X2, present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

Opinion on Prior-Period Financial Statements Different From the Opinion Previously Expressed

.68 If, during the current audit, an auditor becomes aware of circumstances or events that affect the financial statements of a prior period, he or she should consider such matters when updating his or her report on the financial statements of the prior period. For example, if an auditor has previously qualified his or her opinion or expressed an adverse opinion on financial statements of a prior period because of a departure from generally accepted accounting principles, and the prior-period financial statements are restated in the current period to conform with generally accepted accounting principles, the auditor's updated report on the financial statements of the prior period should indicate that the statements have been restated and should express an unqualified opinion with respect to the restated financial statements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.69 *[The following paragraph is effective November 15, 2008. See PCAOB Release 2008-001.]*

If, in an updated report, the opinion is different from the opinion previously expressed on the financial statements of a prior period, the auditor should disclose all the substantive reasons for the different opinion in a separate explanatory paragraph(s) preceding the opinion paragraph of his or her report.[fn 29] The explanatory paragraph(s) should disclose (*a*) the date of the auditor's previous report, (*b*) the type of opinion previously expressed, (*c*) if applicable, a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period, (*d*) the circumstances or events that caused the auditor to express a different opinion, (*e*) if applicable, a reference to the company's disclosure of the correction of the misstatement, and (*f*) the fact that the auditor's updated opinion on the financial statements of the prior period is different from his or her previous opinion on those statements. The following is an example of an explanatory paragraph that may be appropriate when an auditor issues an updated report on the financial statements

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(footnote continued)

of application of generally accepted accounting principles. See PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, for a discussion of consistency. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995; the former footnote 29 has been deleted and subsequent footnotes renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

of a prior period that contains an opinion different from the opinion previously expressed:

Independent Auditor's Report

[*Same first and second paragraphs as the standard report*]

In our report dated March 1, 20X2, we expressed an opinion that the 20X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 20X1 financial statements to conform with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the 20X1 financial statements, as presented herein, is different from that expressed in our previous report. [26]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

Report of Predecessor Auditor

.70 A predecessor auditor ordinarily would be in a position to reissue his or her report on the financial statements of a prior period at the request of a former client if he or she is able to make satisfactory arrangements with the former client to perform this service and if he or she performs the procedures described in paragraph .71.[27] [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

Predecessor Auditor's Report Reissued

.71 Before reissuing (or consenting to the reuse of) a report previously issued on the financial statements of a prior period, when those financial statements are to be presented on a comparative basis with audited financial statements of a subsequent period, a predecessor auditor should consider whether his or her previous report on those statements is still appropriate. Either the current form or manner of presentation of the financial statements of the prior period or one or more subsequent events might make a predecessor auditor's previous report inappropriate. Consequently, a predecessor auditor should (*a*) read the financial statements of the current period, (*b*) compare the prior-period financial statements that he or she reported on with the financial statements

[26] See footnote 17. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

[27] It is recognized that there may be reasons why a predecessor auditor's report may not be reissued and this section does not address the various situations that could arise. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

to be presented for comparative purposes, and (*c*) obtain representation letters from management of the former client and from the successor auditor. The representation letter from management of the former client should state (*a*) whether any information has come to management's attention that would cause them to believe that any of the previous representations should be modified, and (*b*) whether any events have occurred subsequent to the balance-sheet date of the latest prior-period financial statements reported on by the predecessor auditor that would require adjustment to or disclosure in those financial statements.[28] The representation letter from the successor auditor should state whether the successor's audit revealed any matters that, in the successor's opinion, might have a material effect on, or require disclosure in, the financial statements reported on by the predecessor auditor. Also, the predecessor auditor may wish to consider the matters described in section 543, *Part of Audit Performed by Other Independent Auditors*, paragraphs .10 through .12. However, the predecessor auditor should not refer in his or her reissued report to the report or work of the successor auditor. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. As amended, effective for reports reissued on or after June 30, 1998, by Statement on Auditing Standards No. 85.]

.72 A predecessor auditor who has agreed to reissue his or her report may become aware of events or transactions occurring subsequent to the date of his or her previous report on the financial statements of a prior period that may affect his or her previous report (for example, the successor auditor might indicate in the response that certain matters have had a material effect on the prior-period financial statements reported on by the predecessor auditor). In such circumstances, the predecessor auditor should make inquiries and perform other procedures that he or she considers necessary (for example, reviewing the working papers of the successor auditor as they relate to the matters affecting the prior-period financial statements). The auditor should then decide, on the basis of the evidential matter obtained, whether to revise the report. If a predecessor auditor concludes that the report should be revised, he or she should follow the guidance in paragraphs .68, .69, and .73 of this section. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

.73 *[The following paragraph is effective November 15, 2008. See PCAOB Release 2008-001.]*

A predecessor auditor's knowledge of the current affairs of his former client is obviously limited in the absence of a continuing relationship. Consequently, when reissuing the report on prior-period financial statements, a predecessor auditor should use the date of his or her previous report to avoid any implication that he or she has examined any records, transactions, or events after that date. If the predecessor auditor revises the report or if the financial statements are adjusted, he or she should dual-date the report. (See section 530, *Dating of the Independent Auditor's Report*, paragraph .05.) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

Predecessor Auditor's Report Not Presented

.74 *[The following paragraph is effective November 15, 2008. See PCAOB Release 2008-001.]*

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[28] See section 333, *Management Representations*, appendix C [paragraph .18], "Illustrative Updating Management Representation Letter." [Footnote added, effective for reports reissued on or after June 30, 1998, by Statement on Auditing Standards No. 85. Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

If the financial statements of a prior period have been audited by a predecessor auditor whose report is not presented, the successor auditor should indicate in the introductory paragraph of his or her report (*a*) that the financial statements of the prior period were audited by another auditor,[29] (*b*) the date of his or her report, (*c*) the type of report issued by the predecessor auditor, and (*d*) if the report was other than a standard report, the substantive reasons therefor.[30] An example of a successor auditor's report when the predecessor auditor's report is not presented is shown below:

Independent Auditor's Report

> We have audited the balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, were audited by other auditors whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.
>
> [*Same second paragraph as the standard report*]
>
> In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

If the predecessor auditor's report was other than a standard report, the successor auditor should describe the nature of and reasons for the explanatory paragraph added to the predecessor's report or the opinion qualification. Following is an illustration of the wording that may be included in the successor auditor's report:

> . . . were audited by other auditors whose report dated March 1, 20X2, on those statements included an explanatory paragraph that described the change in the Company's method of computing depreciation discussed in Note X to the financial statements.

If the financial statements have been adjusted, the introductory paragraph should indicate that a predecessor auditor reported on the financial statements of the prior period before the adjustments. In addition, if the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the adjustments, he or she may also include the following paragraph in the auditor's report:

> We also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

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[29] The successor auditor should not name the predecessor auditor in his or her report; however, the successor auditor may name the predecessor auditor if the predecessor auditor's practice was acquired by, or merged with, that of the successor auditor. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 85, November 1997. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

[30] If the predecessor's report was issued before the effective date of this section and contained an uncertainties explanatory paragraph, a successor auditor's report issued or reissued after the effective date hereof should not make reference to the predecessor's previously required explanatory paragraph. [Footnote added, effective for reports issued or reissued on or after February 29, 1996, by Statement on Auditing Standards No. 79. Footnote renumbered by the issuance of Statement on Auditing Standards No. 85, November 1997. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

[Paragraph renumbered and amended, effective for reports issued or reissued on or after February 29, 1996, by the issuance of Statement on Auditing Standards No. 79.]

Effective Date and Transition

.75 This section is effective for reports issued or reissued on or after February 29, 1996. Earlier application of the provisions of this section is permissible. [Paragraph renumbered and amended, effective for reports issued or reissued on or after February 29, 1996, by the issuance of Statement on Auditing Standards No. 79.]

.76 An auditor who previously included an uncertainties explanatory paragraph in a report should not repeat that paragraph and is not required to include an emphasis paragraph related to the uncertainty in a reissuance of that report or in a report on subsequent periods' financial statements, even if the uncertainty has not been resolved. If the auditor decides to include an emphasis paragraph related to the uncertainty, the paragraph may include an explanation of the change in reporting standards.[31] [Paragraph renumbered and amended, effective for reports issued or reissued on or after February 29, 1996, by the issuance of Statement on Auditing Standards No. 79.]

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[31] [Footnote renumbered and deleted by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 85, November 1997. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

AU Section 9508

Reports on Audited Financial Statements: Auditing Interpretations of Section 508

Source: Auditing Standard Nos. 8–15.

1. Report of an Outside Inventory-Taking Firm as an Alternative Procedure for Observing Inventories

.01 *Question*—Section 508, *Reports on Audited Financial Statements*, paragraph .24 states that "Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors. . . ." A footnote to that paragraph states: "Circumstances such as the timing of the work may make it impossible for the auditor to accomplish these procedures. In this case, if the auditor is able to satisfy himself or herself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of the work, and the report need not include reference to the omission of the procedures or to the use of alternative procedures." Outside firms of nonaccountants specializing in the taking of physical inventories are used at times by some companies, such as retail stores, hospitals, and automobile dealers, to count, list, price and subsequently compute the total dollar amount of inventory on hand at the date of the physical count. Would obtaining the report of an outside inventory-taking firm be an acceptable alternative procedure to the independent auditor's own observation of physical inventories?

.02 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Interpretation—Sufficient appropriate evidential matter for inventories is discussed in section 331, *Inventories*, paragraphs .09–.12. Section 331.09 states that ". . . it is ordinarily necessary for the independent auditor to be present at the time of count and, by suitable observation, tests, and inquiries, satisfy himself respecting the effectiveness of the methods of inventory-taking and the measure of reliance which may be placed upon the client's representations about the quantities and physical condition of the inventories."

.03 Section 331.10 and .11 discusses two variations of that procedure when the client has well-kept perpetual records that are checked periodically by comparisons with physical counts or when the client uses statistical sampling to determine inventories. In such instances, the auditor may vary the timing and extent of his observation of physical counts, but he "must be present to observe such counts as he deems necessary and must satisfy himself as to the effectiveness of the counting procedures used."

.04 Section 331.12 deals with circumstances in which the auditor has not satisfied himself or herself as to inventories in the possession of the client through procedures described in section 331.09–.11. In those circumstances, the general requirement for satisfactory alternative procedures is that ". . . tests of the accounting records alone will not be sufficient for him to become satisfied as to quantities; it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions."

.05 The fact that the inventory is counted by an outside inventory firm of nonaccountants is not, by itself, a satisfactory substitute for the auditor's own observation or taking of some physical counts. The auditor's concern, in this respect, is to satisfy himself as to the effectiveness of the counting procedures used. If the client engages an outside inventory firm to take the physical inventory, the auditor's primary concern would be to evaluate the effectiveness of the procedures used by the outside firm and his auditing procedures would be applied accordingly.

.06 Thus, the auditor would examine the outside firm's program, observe its procedures and controls, make or observe some physical counts of the inventory, recompute calculations of the submitted inventory on a test basis and apply appropriate tests to the intervening transactions. The independent auditor ordinarily may reduce the extent of the work on the physical count of inventory because of the work of an outside inventory firm, but any restriction on the auditor's judgment concerning the extent of his or her contact with the inventory would be a scope restriction.

[Issue Date: July, 1975; Revised: October, 2000.]

[2.] Reporting on Comparative Financial Statements of Nonprofit Organizations

[.07–.10] [Superseded by Statement on Auditing Standards No. 15, effective for periods ending after June 30, 1977.]

[3.] Reporting on Loss Contingencies

[.11–.14] [Superseded by Statement on Auditing Standards No. 58, effective for reports issued or reissued on or after January 1, 1989.] (See section 508.)

[4.] Reports on Consolidated Financial Statements That Include Supplementary Consolidating Information

[.15–.20] [Superseded December 31, 1980, by SAS No. 29.] (See section 551.)

[5.] Disclosures of Subsequent Events

[.21–.24] [Superseded by Statement on Auditing Standards No. 58, effective for reports issued or reissued on or after January 1, 1989.] (See section 508.)

[6.] The Materiality of Uncertainties

[.25–.28] [Superseded by Statement on Auditing Standards No. 58, effective for reports issued or reissued on or after January 1, 1989.] (See section 508.)

[7.] Reporting on an Uncertainty

[.29–.32] [Withdrawn August, 1982 by Statement on Auditing Standards No. 43.]

8. Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting

.33 *Question*—Footnote 6 of Statement of Position 93-3, *Rescission of Accounting Principles Board Statements*, states that an enterprise is not viewed as

a going concern if liquidation appears imminent. How should the auditor report on financial statements that are prepared on a liquidation basis of accounting for an entity in liquidation or for which liquidation appears imminent?

.34 *Answer*—A liquidation basis of accounting may be considered generally accepted accounting principles for entities in liquidation or for which liquidation appears imminent. Therefore, the auditor should issue an unqualified opinion on such financial statements, provided that the liquidation basis of accounting has been properly applied, and that adequate disclosures are made in the financial statements.

.35 Typically, the financial statements of entities that adopt a liquidation basis of accounting are presented along with financial statements of a period prior to adoption of a liquidation basis that were prepared on the basis of generally accepted accounting principles for going concerns. In such circumstances, the auditor's report ordinarily should include an explanatory paragraph that states that the entity has changed the basis of accounting used to determine the amounts at which assets and liabilities are carried from the going concern basis to a liquidation basis.

.36 Examples of auditor's reports with such an explanatory paragraph follow.

Report on Single Year Financial Statements in Year of Adoption of Liquidation Basis

> "We have audited the statement of net assets in liquidation of XYZ Company as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2. In addition, we have audited the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.
>
> "We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.
>
> "As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 20X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.
>
> "In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets in liquidation of XYZ Company as of December 31, 20X2, the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the results of its operations and its cash flows for the period from January 1, 20X2 to April 25, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described in the preceding paragraph."

Report on Comparative Financial Statements in Year of Adoption of Liquidation Basis

> "We have audited the balance sheet of XYZ Company as of December 31, 20X1, the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2. In addition, we have audited the statement of net assets in liquidation as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.
>
> "We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
>
> "As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 20X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.
>
> "In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company as of December 31, 20X1, the results of its operations and its cash flows for the year then ended and for the period from January 1, 20X2 to April 25, 20X2, its net assets in liquidation as of December 31, 20X2, and the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described in the preceding paragraph."

.37 The auditor may, in subsequent years, continue to include an explanatory paragraph in his report to emphasize that the financial statements are presented on a liquidation basis of accounting.

[.38] [Paragraph deleted to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 79.]

[Issue Date: December, 1984; Revised: June, 1993; Revised: February, 1997; Revised: October, 2000.]

[9.] Quantifying Departures From Generally Accepted Accounting Principles

[.39–.43] [Superseded by Statement on Auditing Standards No. 58, effective for reports issued or reissued on or after January 1, 1989.] (See section 508.)

[10.] Updated Reports Resulting From the Retroactive Suspension of Earnings per Share and Segment Information Disclosure Requirements

[.44–.48] [Withdrawn March, 1989 by the Auditing Standards Board.]

[11.] Restating Financial Statements Reported on by a Predecessor Auditor

[.49–.50] [Superseded by Statement on Auditing Standards No. 84, effective with respect to acceptance of an engagement after March 31, 1998.] (See section 315.)

12. Reference in Auditor's Standard Report to Management's Report

.51 *Question*—One of the basic elements of the auditor's standard report is a statement that the financial statements are the responsibility of the Company's management. That statement is required in the auditor's report even when a document containing the auditor's report includes a statement by management regarding its responsibility for the presentation of the financial statements. When an annual shareholders' report (or other client-prepared document that includes audited financial statements) contains a management report that states the financial statements are the responsibility of management, is it permissible for the auditor's report to include a reference to the management report?

.52 *Interpretation*—No. The statement about management's responsibilities for the financial statements required by section 508, *Reports on Audited Financial Statements*, should not be further elaborated upon in the auditor's standard report or referenced to management's report. Such modifications to the standard auditor's report may lead users to erroneously believe that the auditor is providing assurances about representations made by management about their responsibility for financial reporting, internal controls and other matters that might be discussed in the management report.

[Issue Date: January, 1989.]

[13.] Reference to Country of Origin in the Auditor's Standard Report

[.53–.55] [Withdrawn October, 2000 by SAS No. 93.]

14. Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing

.56 *Question*— Section 508, *Reports on Audited Financial Statements*, states that a basic element of the auditor's report is a statement that the audit was conducted in accordance with generally accepted auditing standards and an identification of the United States of America as the country of origin of those standards. If the auditor conducts the audit in accordance with standards generally accepted in the United States of America and in accordance with the International Standards on Auditing promulgated by the International Auditing Practices Committee of the International Federation of Accountants, may the auditor so indicate in the auditor's report?

.57 *Interpretation*—Yes. Section 508 requires that the auditor indicate in the auditor's report that the audit was conducted in accordance with generally accepted auditing standards and an identification of the United States of America as the country of origin of those standards; however, section 508 does not prohibit the auditor from indicating that the audit also was conducted in accordance with another set of auditing standards. If the audit also was conducted in accordance with the International Standards on Auditing, in their entirety, the auditor may so indicate in the auditor's report. To determine whether an audit

was conducted in accordance with the International Standards on Auditing, it is necessary to consider the text of the International Standards on Auditing in their entirety, including the basic principles and essential procedures together with the related guidance included in the International Standards on Auditing.[1]

.58 When reporting on an audit performed in accordance with auditing standards generally accepted in the United States of America and International Standards on Auditing, the auditor should comply with reporting standards generally accepted in the United States of America.

.59 An example of reporting on an audit conducted in accordance with auditing standards generally accepted in the United States and in accordance with International Standards on Auditing follows:

> We conducted our audit in accordance with auditing standards generally accepted in the United States of America and in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

[Issue Date: March, 2002.]

15. Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations [2]

.60 *Question*—If the prior-period financial statements audited by a predecessor auditor who has ceased operations are presented for comparative purposes with current-period audited financial statements, how is the successor auditor's report affected?

.61 *Interpretation*—If the prior-period audited financial statements are *unchanged*, pursuant to section 508, *Reports on Audited Financial Statements*, paragraph .74, the successor auditor should indicate in the introductory paragraph of his or her report (*a*) that the financial statements of the prior period were audited by another auditor, (*b*) the date of the predecessor auditor's report, (*c*) the type of report issued by the predecessor auditor, and (*d*) if the report was other than a standard report, the substantive reasons therefor. The successor auditor ordinarily also should indicate that the other auditor has ceased operations. Footnote 29 of section 508 indicates that the successor auditor should not name the predecessor auditor in the report. An example of the reference that would be added to the introductory paragraph of the successor auditor's report is presented as follows:

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[1] Appendix B, *Analysis of International Standards on Auditing*, identifies sections and paragraphs, if applicable, within the International Standards on Auditing that may require procedures and documentation in addition to those required by U.S. auditing standards.

[2] A firm is considered to have ceased operations when it no longer issues audit opinions either in its own name or in the name of a successor firm. A firm may cease operations with respect to public entities and still issue audit opinions with respect to non-public entities.

> The financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated March 31, 20X2.

A reference to the predecessor auditor's report should be included even if the predecessor auditor's report on the prior-period financial statements is reprinted and accompanies the successor auditor's report, because reprinting does not constitute reissuance of the predecessor auditor's report.

.62 If the prior-period financial statements *have been restated*, and the entity does not file annual financial statements with the Securities and Exchange Commission (SEC), the successor auditor should follow the guidance in paragraph .61 above, indicating that the predecessor auditor reported on such financial statements before restatement.

.63 When the prior-period financial statements have been restated, the successor auditor may be engaged either to reaudit the prior-period financial statements or to audit only the restatement adjustments. If the successor auditor is engaged to audit only the restatement adjustments and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments, the successor auditor may report on the restatement adjustments using the guidance in section 508.74. (The auditor also may use the guidance on alternative language contained in paragraph .71, below.) In determining the nature, timing and extent of procedures, the successor auditor should consider that a predecessor auditor who has ceased operations cannot perform the procedures to evaluate the appropriateness of the restatement adjustments as described in section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

.64 If the successor auditor neither performs a reaudit of the prior-period financial statements nor audits only the restatement adjustments, the note to the financial statements describing the restatement adjustments should be marked "Unaudited." Depending on the nature and extent of the restatement adjustments, it may be appropriate for the prior-period financial statements to be marked "Unaudited."

.65 If the entity files annual financial statements with the SEC, the SEC staff has indicated (specifically with respect to Arthur Andersen LLP) that, in annual reports (on Form 10-K and to shareholders), the predecessor auditor's latest signed and dated report on the prior-period financial statements should be reprinted with a legend indicating (*a*) that the report is a copy of the previously issued report and (*b*) that the predecessor auditor has not reissued the report.[3]

.66 The successor auditor should refer to the predecessor auditor's report in his or her report, as described in paragraph .61 above, and, if the prior-period financial statements *have been restated*, indicate that the predecessor auditor reported on such financial statements before restatement.

.67 SEC rules require that annual and, in some instances, other financial statements be audited. To satisfy the SEC audit requirement when the prior-period financial statements have been restated, the successor auditor may be engaged either to reaudit the prior-period financial statements or to audit only the restatement adjustments. A successor auditor who is engaged to audit only

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[3] See Securities and Exchange Commission Release No. 33-8070, *Requirements for Arthur Andersen LLP Auditing Clients*.

the restatement adjustments is not required to perform procedures to identify all adjustments to the financial statements that may be appropriate.[4]

.68 In some cases, prior-period financial statement disclosures may be revised in a manner that does not involve restating amounts in the prior-period financial statements, but rather involves the addition of disclosures. In such cases, the successor auditor may be engaged to perform audit procedures to satisfy himself or herself as to the appropriateness of the additional disclosures. Financial statements that have been revised are considered to be restated for the purposes of this Interpretation.

.69 Some revisions may be sufficiently inconsequential such that audit procedures by the successor auditor would be unnecessary and the reference to the predecessor auditor's report on the prior-period financial statements would not indicate that the predecessor auditor reported on such financial statements before restatement. For example, inconsequential revisions might include conforming editorial modifications to footnote disclosures or reclassifications made for comparative purposes in the financial statements.[5]

.70 When the successor auditor is engaged to audit only the restatement adjustments, the procedures performed will vary significantly depending on the nature of adjustment. In some instances, the successor auditor may determine that conducting a reaudit of the prior-period financial statements is necessary based on the nature of the restatement adjustments. Examples of restatement adjustments whose nature indicates that a reaudit ordinarily is necessary (particularly with respect to entities that file financial statements with the SEC) include, but are not limited to:

- Corrections of an error.
- Reflection of a change in reporting entity.
- Retroactive accounting changes (*a*) with significant impact on previously reported amounts or (*b*) that affect previously reported net income or net assets.
- Reporting discontinued operations.
- Changes affecting previously reported net income or net assets.

.71 If the successor auditor is engaged to audit only the restatement adjustments and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments, the successor auditor may report on the restatement adjustments using the guidance in section 508.74. Alternatively, the successor auditor may wish to make it clear that he or she did not audit, review, or apply other procedures to the prior-period financial statements beyond the procedures applied to the restatement adjustments. Accordingly, he or she may include the following paragraph in his or her report:

> As discussed above, the financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. As described in Note X, these financial statements have

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[4] However, a successor auditor who identifies other adjustments that may be appropriate to the prior-period financial statements, either in the course of auditing the restatement adjustments or in the audit of current-period financial statements, should consider their effect on the prior-period financial statements. See section 315. Section 561 provides further guidance that may be useful to a successor auditor who either reaudits the prior-period financial statements or audits only the restatement adjustments.

[5] If reclassifications result in material changes to prior-period financial statements, they should be disclosed and the successor auditor would, at a minimum, need to perform audit procedures on the related restatement adjustments.

been restated [revised]. We audited the adjustments described in Note X that were applied to restate [revise] the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied. However, we were not engaged to audit, review, or apply any procedures to the 20X1 financial statements of the Company other than with respect to such adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 20X1 financial statements taken as a whole.

.72 If the auditor wishes to identify the procedures performed in his or her report, he or she may include in his or her report a paragraph similar to the following example:

Restatement Adjustments for Changes in Segment Composition

As discussed above, the financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. As described in Note X, the Company changed the composition of its reportable segments in 20X2, and the amounts in the 20X1 financial statements relating to reportable segments have been restated to conform to the 20X2 composition of reportable segments. We audited the adjustments that were applied to restate the disclosures for reportable segments reflected in the 20X1 financial statements. Our procedures included (*a*) agreeing the adjusted amounts of segment revenues, operating income and assets to the Company's underlying records obtained from management, and (*b*) testing the mathematical accuracy of the reconciliations of segment amounts to the consolidated financial statements. In our opinion, such adjustments are appropriate and have been properly applied. However, we were not engaged to audit, review, or apply any procedures to the 20X1 financial statements of the Company other than with respect to such adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 20X1 financial statements taken as a whole.

.73 When the revision of the prior-period financial statements is limited to expansion of footnote disclosure, the phrase "restatement adjustments" may not be applicable. In such circumstances, the auditor may include in his or her report a paragraph similar to the following example:

Addition of FAS 142, paragraph 61, Disclosure

As discussed above, the financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. As described in Note X, these financial statements have been revised to include the transitional disclosures required by Statement of Financial Accounting Standards (Statement) No. 142, *Goodwill and Other Intangible Assets,* which was adopted by the Company as of January 1, 20X2. Our audit procedures with respect to the disclosures in Note X with respect to 20X1 included (*a*) agreeing the previously reported net income to the previously issued financial statements and the adjustments to reported net income representing amortization expense (including any related tax effects) recognized in those periods related to goodwill, intangible assets that are no longer being amortized, deferred credits related to an excess over cost, equity method goodwill, and changes in amortization periods for intangible assets that will continue to be amortized as a result of initially applying Statement No. 142 (including any related tax effects) to the Company's underlying records obtained from management, and (*b*) testing the mathematical accuracy of the reconciliation of adjusted net income to reported net income, and the related earnings-per-share amounts. In our opinion, the disclosures for 20X1 in Note X are appropriate. However, we were not engaged to audit, review, or apply any procedures to the 20X1 financial statements of the Company other than with respect to such

disclosures and, accordingly, we do not express an opinion or any other form of assurance on the 20X1 financial statements taken as a whole.

.74 *Question*—If the prior-period financial statements audited by a predecessor auditor who has ceased operations have been subsequently restated, but the successor auditor has not yet completed an audit of current-period financial statements, can the successor auditor report on the restatement adjustments pursuant to section 508.74?

.75 *Interpretation*—No. Section 508.74 is only applicable when the prior-period financial statements are presented for comparative purposes with current-period audited financial statements. If the prior-period financial statements have been restated, and the successor auditor is requested to report on those financial statements without also reporting on current-period audited financial statements, the successor auditor would need to reaudit the prior-period financial statements in order to report on them.

[Issue Date: November, 2002.]

16. Effect on Auditor's Report of Omission of Schedule of Investments by Investment Partnerships That Are Exempt From Securities and Exchange Commission Registration Under the Investment Company Act of 1940

.76 *Question*—The Audit and Accounting Guide *Audits of Investment Companies* (the Guide) addresses financial statement presentation and disclosure requirements for investment partnerships that are exempt from Securities and Exchange Commission (SEC) registration under the Investment Company Act of 1940 (the 1940 Act). Paragraphs 7.10 through 7.14 of the Guide specifically describe information that should be disclosed in a Schedule of Investments. Paragraph 7.12 of the Guide states that the financial statements of an investment partnership that is exempt from SEC registration under the Investment Company Act of 1940, when prepared in conformity with generally accepted accounting principles, should:

a. Categorize investments by the following:

(i) Type (such as common stocks, preferred stocks, convertible securities, fixed-income securities, government securities, options purchased, options written, warrants, futures, loan participations, short sales, other investment companies, and so forth)

(ii) Country or geographic region

(iii) Industry

Report (1) the percent of net assets that each such category represents and (2) the total value and cost for each category in (*a*)(i) and (*a*)(ii).

b. Disclose the name, shares or principal amount, value, and type of the following:

(i) Each investment (including short sales), constituting more than 5 percent of net assets

(ii) All investments in any one issuer aggregating more than 5 percent of net assets

In applying the 5 percent test, total long and total short positions in any one issuer should be considered separately.

c. Aggregate other investments (each of which is 5 percent or less of net assets) without specifically identifying the issuers of such investments and categorize them as required by (*a*) above.

.77 Section 508.41 addresses the effect of inadequate disclosure of information essential for fair presentation of the financial statements on the auditor's report. It states:

> If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express a qualified or adverse opinion because of the departure from those principles and should provide the information in the report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific Statement on Auditing Standards.

.78 Section 508.42 provides an example of a report qualified for inadequate disclosure (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate) as follows:

> Independent Auditor's Report
>
> [*Same first and second paragraphs as the standard report*]
>
> The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.
>
> In our opinion, except for the omission of the information discussed in the preceding paragraph, . . .

.79 The Guide does not make it clear how the guidance in section 508.41 and .42 should be applied to reports on financial statements of investment partnerships that are exempt from SEC registration and that do not include all the investment information required in the Schedule of Investments as required by the Guide. For example, if the financial statements did not disclose each of the required items for each investment, the guidance in section 508.41 indicates the auditor should, if practicable, include the missing information (for example, the Schedule of Investments or information about individual investments) in the auditor's report. However, the example in section 508.42 provides that the auditor would disclose the nature of the missing information, rather than the actual information, in the auditor's report.

.80 In applying section 508.41 and .42 to an auditor's report on financial statements of an investment partnership that is exempt from SEC registration and that does not include the required Schedule of Investments information required by paragraph 7.12 of the Guide, is it sufficient for the auditor to describe "the nature of the omitted disclosures" in his or her report expressing a qualified (or adverse) opinion?

.81 *Interpretation*—No. The example in section 508.42 does not change the requirement in section 508.41 for the auditor to issue a qualified or adverse opinion and also to provide the missing information, if practicable. If the investment disclosures required by the Guide are not included in the financial statements and it is practicable for the auditor to determine them or any portion thereof, the auditor should include the information in his or her report expressing the qualified or adverse opinion.

.82 Footnote 15 of section 508 indicates that it is practicable to provide the missing information if "the information is reasonably obtainable from management's accounts and records and . . . providing the information in the report does not require the auditor to assume the position of a preparer of financial information." Ordinarily, it would be practicable for the auditor to obtain and present the information about investments constituting more than 5 percent of net assets called for by section (*b*) of the disclosure requirement described in paragraph .76 above. However, due to the need to categorize the investments

for the purpose of preparing the schedule called for by section (*a*) of the disclosure requirement described in paragraph .76 above, the auditor might be in the position of preparer of financial information and, therefore, would not include the schedule in his or her report. In rare cases, the Schedule of Investments information may be so limited that the auditor may conclude that disclosure of the entire Schedule is practicable.

.83 Following is an illustration of a report that expresses a qualified opinion because the Schedule of Investments fails to disclose investments constituting more than 5 percent of net assets, but in all other respects conforms to the requirements of the Guide:

Independent Auditor's Report

[*Same first and second paragraphs as the standard report*]

The Schedule of Investments included in the Partnership's financial statements does not disclose required information about the following investments, each constituting more than 5 percent of the Partnership's total net assets, at December 31, 20X2:

- Amalgamated Buggy Whips, Inc., 10,000 shares of common stock—fair value $3,280,000 (Consumer nondurable goods)
- Paper Airplane Corp., 6.25% Cv. Deb. due 20XX, $4.5 million par value—fair value $4,875,000 (Aviation)

In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements and financial highlights referred to above present fairly, . . .

.84 An illustration of an adverse opinion relating to failure to present the entire Schedule of Investments and all of the related required information follows.[6] This illustration assumes that the auditor has concluded that it is not practicable to present all of the required information. In such circumstances, the auditor presents in his or her report the missing information, where it is practicable to do so, and describes the nature of the missing information where it is not practicable to present the information in the report:

Independent Auditor's Report

[*Same first and second paragraphs as the standard report*]

The Partnership has declined to prepare and present a Schedule of Investments and the related information as of December 31, 20X2. Accounting principles generally accepted in the United States of America require presentation of this Schedule and the related information. Presentation of this Schedule would have disclosed required information about the following investments, each constituting more than 5 percent of the Partnership's total net assets, at December 31, 20X2:

- Amalgamated Buggy Whips, Inc., 10,000 shares of common stock—fair value $3,280,000 (Consumer nondurable goods)[7]

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[6] Section 508.36 discusses the factors the auditor considers in deciding whether to issue a qualified opinion or an adverse opinion.

[7] In the absence of a Schedule of Investments containing categorizations by type, country or geographic region, and industry, such categorizations should be provided only if readily ascertainable from management's accounts and records. The auditor should not assign such categorizations if management has not done so.

- Paper Airplane Corp., 6.25% Cv. Deb. due 20XX, $4.5 million par value—fair value $4,875,000 (Aviation)

In addition, presentation of the Schedule of Investments would have disclosed [*describe the nature of the information that it is not practicable to present in the auditor's report*].

In our opinion, because the omission of a Schedule of Investments results in an incomplete presentation as explained in the preceding paragraph, the financial statements and financial highlights referred to above do not present fairly, . . .

[Issue Date: April 9, 2003.]

AU Section 530

Dating of the Independent Auditor's Report

Source: SAS No. 1, section 530; SAS No. 29; SAS No. 98; Auditing Standard No. 5; Auditing Standard Nos. 8–15.

Issue date, unless otherwise indicated: November, 1972.

.01 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the auditor's opinion. Paragraph .05 describes the procedure to be followed when a subsequent event occurring after the report date is disclosed in the financial statements.

> Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor's reports on the company's financial statements and on internal control over financial reporting should be dated the same date.
>
> Note: If the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion on the financial statements, then the auditor's report date is the date that the auditor has obtained sufficient appropriate evidence to support the representations in the auditor's report.

.02 The auditor has no responsibility to make any inquiry or carry out any auditing procedures for the period after the date of his report.[1] However, with respect to filings under the Securities Act of 1933, reference should be made to section 711.10–.13.[*]

Events Occurring After the Date of the Independent Auditor's Report But Before Issuance of Report

.03 In case a subsequent event of the type requiring adjustment of the financial statements (as discussed in section 560.03) occurs after the date of the independent auditor's report but before the issuance of the related financial statements, and the event comes to the attention of the auditor, the financial statements should be adjusted or the auditor should qualify his or her opinion.[2] When the adjustment is made without disclosure of the event, the report ordinarily should be dated in accordance with paragraph .01. However, if the financial statements are adjusted and disclosure of the event is made, or if no adjustment is made and the auditor qualifies his or her opinion,[3] the procedures

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[1] See section 561 regarding procedures to be followed by the auditor who, subsequent to the date of his report upon audited financial statements, becomes aware that facts may have existed at that date which might have affected his report had he then been aware of such facts.

[*] Section number revised, April 1981, by the issuance of Statement on Auditing Standards No. 37.

[2] In some cases, a disclaimer of opinion or an adverse opinion may be appropriate.

[3] Ibid.

set forth in paragraph .05 should be followed. [As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.04 In case a subsequent event of the type requiring disclosure (as discussed in section 560.05) occurs after the date of the auditor's report but before the issuance of the related financial statements, and the event comes to the attention of the auditor, it should be disclosed in a note to the financial statements or the auditor should qualify his or her opinion.[4] If disclosure of the event is made, either in a note or in the auditor's report, the auditor would date the report as set forth in the following paragraph. [As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.05 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The independent auditor has two methods for dating the report when a subsequent event disclosed in the financial statements occurs after the auditor has obtained sufficient appropriate evidence on which to base his or her opinion, but before the issuance of the related financial statements. The auditor may use "dual dating," for example, "February 16, 20__, except for Note __, as to which the date is March 1, 20__," or may date the report as of the later date. In the former instance, the responsibility for events occurring subsequent to the original report date is limited to the specific event referred to in the note (or otherwise disclosed). In the latter instance, the independent auditor's responsibility for subsequent events extends to the later report date and, accordingly, the procedures outlined in section 560.12 generally should be extended to that date.

Reissuance of the Independent Auditor's Report

.06 An independent auditor may reissue his report on financial statements contained in annual reports filed with the Securities and Exchange Commission or other regulatory agencies or in a document he submits to his client or to others that contains information in addition to the client's basic financial statements subsequent to the date of his original report on the basic financial statements. An independent auditor may also be requested by his client to furnish additional copies of a previously issued report. Use of the original report date in a reissued report removes any implication that records, transactions, or events after that date have been examined or reviewed. In such cases, the independent auditor has no responsibility to make further investigation or inquiry as to events which may have occurred during the period between the original report date and the date of the release of additional reports. However, see section 711[*] as to an auditor's responsibility when his report is included in a registration statement filed under the Securities Act of 1933 and see section 508.70-.73, for the predecessor auditor's responsibility when reissuing or consenting to the reuse of a report previously issued on the financial statements of a prior period. [As modified, effective December 31, 1980, by SAS No. 29.] (See section 551.)

.07 In some cases, it may not be desirable for the independent auditor to reissue his report in the circumstances described in paragraph .06 because he has become aware of an event that occurred subsequent to the date of his original report that requires adjustment or disclosure in the financial statements. In such cases, adjustment with disclosure or disclosure alone should be made as

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[4] Ibid.

[*] Section number revised, April 1981, by the issuance of Statement on Auditing Standards No. 37.

described in section 560.08. The independent auditor should consider the effect of these matters on his opinion and he should date his report in accordance with the procedures described in paragraph .05.

.08 However, if an event of the type requiring disclosure only (as discussed in section 560.05 and 560.08) occurs between the date of the independent auditor's original report and the date of the reissuance of such report, and if the event comes to the attention of the independent auditor, the event may be disclosed in a separate note to the financial statements captioned somewhat as follows:

Event (Unaudited) Subsequent to the Date of the Independent Auditor's Report

Under these circumstances, the report of the independent auditor would carry the same date used in the original report.

AU Section 532

Restricting the Use of an Auditor's Report

Source: SAS No. 87; Auditing Standard No. 16.

Effective for reports issued after December 31, 1998, unless otherwise indicated.

Introduction and Applicability

.01 This section provides guidance to auditors on restricting the use of reports issued pursuant to Statements on Auditing Standards (SASs).[1] This section—

- Defines the terms *general use* and *restricted use*.
- Describes the circumstances in which the use of auditors' reports should be restricted.
- Specifies the language to be used in auditors' reports that are restricted as to use.

The reporting guidance in paragraph .19 of this section is not applicable to reports issued under section 324, *Service Organizations*, or reports issued under section 634, *Letters for Underwriters and Certain Other Requesting Parties*.

General-Use and Restricted-Use Reports

.02 The term *general use* applies to auditors' reports that are not restricted to specified parties. Auditors' reports on financial statements prepared in conformity with generally accepted accounting principles or certain comprehensive bases of accounting other than generally accepted accounting principles[2] ordinarily are not restricted as to use.[3,4]

.03 The term *restricted use* applies to auditors' reports intended only for specified parties. The need for restriction on the use of a report may result from a number of circumstances, including the purpose of the report, the nature of the procedures applied in its preparation, the basis of or assumptions used in its preparation, the extent to which the procedures performed generally are known or understood, and the potential for the report to be misunderstood when taken out of the context in which it was intended to be used.

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[1] Throughout this section, the term *accountant* may be used interchangeably with the term *auditor*. The term accountant refers to a person possessing the professional qualifications required to practice as an independent auditor. See section 110, *Responsibilities and Functions of the Independent Auditor*, paragraphs .04 and .05.

[2] Section 623, *Special Reports*, paragraph .04, defines a comprehensive basis of accounting other than generally accepted accounting principles.

[3] However, see section 623.05*f* for restrictions on the use of reports on financial statements prepared in conformity with the requirements of the financial reporting provisions of a governmental regulatory agency.

[4] Nothing in this section precludes an auditor from restricting the use of any report.

.04 An auditor should restrict the use of a report in the following circumstances.

a. The subject matter of the auditor's report or the presentation being reported on is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with generally accepted accounting principles or an other comprehensive basis of accounting (OCBOA). (See paragraph .05.)

b. The auditor's report is issued as a by-product of a financial statement audit and is based on the results of procedures designed to enable the auditor to express an opinion on the financial statements taken as a whole, not to provide assurance on the specific subject matter of the report. (See paragraphs .07 through 11.)

[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

Reporting on Subject Matter or Presentations Based on Measurement or Disclosure Criteria Contained in Contractual Agreements or Regulatory Provisions

.05 Reports on subject matter or presentations based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with generally accepted accounting principles or an OCBOA are restricted as to use because the basis, assumptions, or purpose of such presentations (contained in such agreements or regulatory provisions) are developed for and directed only to the parties to the agreement or regulatory agency responsible for the provisions.

Reporting When Specified Parties Accept Responsibility for the Sufficiency of the Procedures Performed

[.06] [Paragraph deleted to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

Reporting as a By-Product of a Financial Statement Audit

.07 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

An auditor may issue certain reports on matters coming to his or her attention during the course of an audit of financial statements. Such reports include but are not limited to reports issued pursuant to the following:

- Section 325, *Communications About Control Deficiencies in An Audit of Financial Statements*
- Auditing Standard No. 16, *Communication with Audit Committees*
- Paragraphs .19 through .21 of section 623, *Special Reports*, for reporting on compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements

.08 Reports issued pursuant to the aforementioned auditing standards are based on the results of procedures designed to enable an auditor to express an opinion on the financial statements taken as a whole, not to provide assurance on the specific subject matter of the report. These reports are by-products of an audit of financial statements and are referred to as by-product reports in this section.

.09 Because the issuance of the by-product report is not the primary objective of the engagement, an audit generally includes only limited procedures directed toward the subject matter of the by-product report. Accordingly, because of the potential for misinterpretation or misunderstanding of the limited degree of assurance associated with a by-product report, the use of such reports should be restricted. For example, a report issued under section 325 should be restricted because the purpose of the engagement is to report on an entity's financial statements, not to provide assurance on its internal control.

.10 An auditor may issue a by-product report in connection with other engagements conducted in accordance with generally accepted auditing standards, such as an engagement to express an opinion on one or more specified elements, accounts, or items of a financial statement.

.11 In consideration of the foregoing, the use of by-product reports should be restricted to an entity's audit committee, board of directors, management, others within the organization, specified regulatory agencies, and, in the case of reports on compliance with aspects of contractual agreements, to the parties to the contract or agreement.

Combined Reports Covering Both Restricted-Use and General-Use Subject Matter or Presentations

.12 If an auditor issues a single combined report covering both (*a*) subject matter or presentations that require a restriction on use to specified parties and (*b*) subject matter or presentations that ordinarily do not require such a restriction, the use of such a single combined report should be restricted to the specified parties.

Inclusion of a Separate Restricted-Use Report in the Same Document With a General-Use Report

.13 In some instances, a separate restricted-use report may be included in a document that also contains a general-use report.[5] The inclusion of a separate restricted-use report in a document that contains a general-use report does not affect the intended use of either report. The restricted-use report remains restricted as to use, and the general-use report continues to be for general use.

Adding Other Specified Parties

.14 Subsequent to the completion of an engagement resulting in a restricted-use report, or in the course of such an engagement, an auditor may be asked to consider adding other parties as specified parties.

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[5] Such a requirement exists in audits performed in accordance with U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and U.S. General Accounting Office, *Government Auditing Standards*.

.15 As noted in paragraph .11 of this section, the use of by-product reports should be restricted to an entity's audit committee, board of directors, management, others within the organization, specified regulatory agencies, and, in the case of reports on compliance with aspects of contractual agreements, to the parties to the contract or agreement. An auditor should not agree to add other parties as specified parties of a by-product report.

.16 If an auditor is reporting on subject matter or a presentation based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions, as described in paragraph .05 of this section, the auditor may agree to add other parties as specified parties based on the auditor's consideration of factors such as the identity of the other parties and the intended use of the report. If the auditor agrees to add other parties as specified parties, the auditor should obtain affirmative acknowledgment, ordinarily in writing, from the other parties of their understanding of the nature of the engagement, the measurement or disclosure criteria used in the engagement, and the related report. If the other parties are added after the auditor has issued his or her report, the report may be reissued or the auditor may provide other written acknowledgment that the other parties have been added as specified parties. If the report is reissued, the report date should not be changed. If the auditor provides written acknowledgment that the other parties have been added as specified parties, such written acknowledgment ordinarily should state that no procedures have been performed subsequent to the date of the report.

[.17] [Paragraph deleted to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

Limiting the Distribution of Reports

.18 Because of the reasons presented in paragraph .03 of this section, an auditor should consider informing his or her client that restricted-use reports are not intended for distribution to nonspecified parties, regardless of whether they are included in a document containing a separate general-use report.[6, 7] However, an auditor is not responsible for controlling a client's distribution of restricted-use reports. Accordingly, a restricted-use report should alert readers to the restriction on the use of the report by indicating that the report is not intended to be and should not be used by anyone other than the specified parties.

Report Language—Restricted Use

.19 An auditor's report that is restricted as to use should contain a separate paragraph at the end of the report that includes the following elements:

a. A statement indicating that the report is intended solely for the information and use of the specified parties

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[6] In some cases, restricted-use reports filed with regulatory agencies are required by law or regulation to be made available to the public as a matter of public record. Also, a regulatory agency as part of its oversight responsibility for an entity may require access to restricted-use reports in which they are not named as a specified party.

[7] This section does not preclude an auditor, in connection with establishing the terms of the engagement, from reaching an understanding with the client that the intended use of the report will be restricted, and from obtaining the client's agreement that the client and the specified parties will not distribute the report to parties other than those identified in the report.

b. An identification of the specified parties to whom use is restricted

c. A statement that the report is not intended to be and should not be used by anyone other than the specified parties

An example of such a paragraph is the following:

> This report is intended solely for the information and use of [*the specified parties*][8] and is not intended to be and should not be used by anyone other than these specified parties.

Effective Date

.20 This section is effective for reports issued after December 31, 1998. Early application of the provisions of this section is permitted.

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[8] The report may list the specified parties or refer the reader to the specified parties listed elsewhere in the report. For reports on engagements performed in accordance with U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, the specified parties may be identified as "federal awarding agencies and pass-through entities."

AU Section 534

Reporting on Financial Statements Prepared for Use in Other Countries

Source: SAS No. 51.

See section 9534 for interpretations of this section.

Effective for audits of financial statements for periods beginning after July 31, 1986, unless otherwise indicated.

.01 This section provides guidance for an independent auditor practicing in the United States who is engaged to report on the financial statements of a U.S. entity that have been prepared in conformity with accounting principles generally accepted in another country for use outside the United States.[1] A "U.S. entity" is an entity that is either organized or domiciled in the United States.

Purpose and Use of Financial Statements

.02 A U.S. entity ordinarily prepares financial statements for use in the United States in conformity with accounting principles generally accepted in the United States, but it may also prepare financial statements that are intended for use outside the United States and are prepared in conformity with accounting principles generally accepted in another country. For example, the financial statements of a U.S. entity may be prepared for inclusion in the consolidated financial statements of a non-U.S. parent. A U.S. entity may also have non-U.S. investors or may decide to raise capital in another country. Before reporting on financial statements prepared in conformity with the accounting principles of another country, the auditor should have a clear understanding of, and obtain written representations from management regarding, the purpose and uses of such financial statements. If the auditor uses the standard report of another country, and the financial statements will have general distribution in that country, he should consider whether any additional legal responsibilities are involved.

General and Fieldwork Standards

.03 When auditing the financial statements of a U.S. entity prepared in conformity with accounting principles generally accepted in another country, the auditor should perform the procedures that are necessary to comply with the general and fieldwork standards of U.S. generally accepted auditing standards (GAAS).

.04 The auditing procedures generally performed under U.S. GAAS may need to be modified, however. The assertions embodied in financial statements prepared in conformity with accounting principles generally accepted in another country may differ from those prepared in conformity with U.S. generally

[1] See paragraph .07, however, for a discussion of financial statements prepared in conformity with accounting principles generally accepted in another country for limited distribution in the United States.

accepted accounting principles. For example, accounting principles generally accepted in another country may require that certain assets be revalued to adjust for the effects of inflation—in which case, the auditor should perform procedures to test the revaluation adjustments. On the other hand, another country's accounting principles may not require or permit recognition of deferred taxes; consequently, procedures for testing deferred tax balances would not be applicable. As another example, the accounting principles of some countries do not require or permit disclosure of related party transactions. Determining that such transactions are properly disclosed, therefore, would not be an audit objective in such cases. Other objectives, however, would remain relevant—such as identifying related parties in order to fully understand the business purpose, nature, and extent of the transactions and their effects on the financial statements.

.05 The auditor should understand the accounting principles generally accepted in the other country. Such knowledge may be obtained by reading the statutes or professional literature (or codifications thereof) that establish or describe the accounting principles generally accepted in the other country. Application of accounting principles to a particular situation often requires practical experience; the auditor should consider, therefore, consulting with persons having such expertise in the accounting principles of the other country. If the accounting principles of another country are not established with sufficient authority or by general acceptance, or a broad range of practices is acceptable, the auditor may nevertheless be able to report on financial statements for use in such countries if, in the auditor's judgment, the client's principles and practices are appropriate in the circumstances and are disclosed in a clear and comprehensive manner. In determining the appropriateness of the accounting principles used, the auditor may consider, for example, International Accounting Standards established by the International Accounting Standards Committee.

Compliance With Auditing Standards of Another Country

.06 In those circumstances in which the auditor is requested to apply the auditing standards of another country when reporting on financial statements prepared in conformity with accounting principles generally accepted in that country, the auditor should comply with the general and fieldwork standards of that country as well as with those standards in U.S. GAAS. This may require the auditor to perform certain procedures required by auditing standards of the other country in addition to those required by U.S. GAAS. The auditor will need to read the statutes or professional literature, or codifications thereof, that establish or describe the auditing standards generally accepted in the other country. He should understand, however, that such statutes or professional literature may not be a complete description of auditing practices and, therefore, should consider consulting with persons having expertise in the auditing standards of the other country.

Reporting Standards

.07 If financial statements prepared in conformity with accounting principles generally accepted in another country are prepared for use only outside the United States, the auditor may report using either (*a*) a U.S.-style report modified to report on the accounting principles of another country (see paragraphs .09 and .10) or (*b*) if appropriate, the report form of the other country (see paragraphs .11 and .12). This is not intended to preclude limited distribution of

the financial statements to parties (such as banks, institutional investors, and other knowledgeable parties that may choose to rely on the report) within the United States that deal directly with the entity, if the financial statements are to be used in a manner that permits such parties to discuss differences from U.S. accounting and reporting practices and their significance with the entity.

.08 Financial statements prepared in conformity with accounting principles generally accepted in another country ordinarily are not useful to U.S. users. Therefore, if financial statements are needed for use both in another country and within the United States, the auditor may report on two sets of financial statements for the entity—one prepared in conformity with accounting principles generally accepted in another country for use outside the United States, and the other prepared in accordance with accounting principles generally accepted in the United States (see paragraph .13). If dual statements are not prepared, or for some other reason the financial statements prepared in conformity with accounting principles generally accepted in another country will have more than limited distribution in the United States, the auditor should report on them using the U.S. standard form of report, modified as appropriate for departures from accounting principles generally accepted in the United States (see paragraph .14).

Use Only Outside the United States

.09 A U.S.-style report modified to report on financial statements prepared in conformity with accounting principles generally accepted in another country that are intended for use only outside the United States should include—

a. A title that includes the word "independent."[2]

b. A statement that the financial statements identified in the report were audited.

c. A statement that refers to the note to the financial statements that describes the basis of presentation of the financial statements on which the auditor is reporting, including identification of the nationality of the accounting principles.

d. A statement that the financial statements are the responsibility of the Company's management[3] and that the auditor's responsibility is to express an opinion on the financial statements based on his audit.

e. A statement that the audit was conducted in accordance with auditing standards generally accepted in the United States of America (and, if appropriate, with the auditing standards of the other country).

f. A statement that U.S. standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

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[2] This statement does not require a title for an auditor's report if the auditor is not independent. See section 504, *Association With Financial Statements*, for guidance on reporting when the auditor is not independent. [Footnote added to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62.]

[3] In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility. [Footnote added to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62.]

g. A statement that an audit includes:

(1) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements,

(2) Assessing the accounting principles used and significant estimates made by management, and

(3) Evaluating the overall financial statement presentation.[4]

h. A statement that the auditor believes that his audit provides a reasonable basis for his opinion.

i. A paragraph that expresses the auditor's opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the basis of accounting described. If the auditor concludes that the financial statements are not fairly presented on the basis of accounting described, all substantive reasons for that conclusion should be disclosed in an additional explanatory paragraph (preceding the opinion paragraph) of the report, and the opinion paragraph should include appropriate modifying language as well as a reference to the explanatory paragraph.

j. If the auditor is auditing comparative financial statements and the described basis of accounting has not been applied in a manner consistent with that of the preceding period and the change has had a material effect on the comparability of the financial statements, the auditor should add an explanatory paragraph to his report (following the opinion paragraph) that describes the change in accounting principle and refers to the note to the financial statements that discusses the change and its effect on the financial statements.

k. The manual or printed signature of the auditor's firm.

l. Date.[5]

[As amended to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

.10 The following is an illustration of such a report:

Independent Auditor's Report

We have audited the accompanying balance sheet of International Company as of December 31, 20XX and the related statements of income, retained earnings, and cash flows for the year then ended which, as described in Note X, have been prepared on the basis of accounting principles generally accepted in [*name of country*]. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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[4] Section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, paragraphs .03 and .04, discuss the auditor's evaluation of the overall presentation of the financial statements. [Footnote added to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. Title of section 411 amended, effective for reports issued or reissued on or after June 30, 2001, by Statement on Auditing Standards No. 93.]

[5] For guidance on dating the independent auditor's report, see section 530, *Dating of the Independent Auditor's Report*. [Footnote added to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62.]

> We conducted our audit in accordance with auditing standards generally accepted in the United States of America (and in [*name of country*]). U.S. standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.
>
> In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of International Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in [*name of country*].

[As amended to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

.11 The independent auditor may also use the auditor's standard report of another country, provided that—

a. Such a report would be used by auditors in the other country in similar circumstances.

b. The auditor understands, and is in a position to make, the attestations contained in such a report (see paragraph .12).

The auditor should consider whether the standard report of another country or the financial statements may be misunderstood because they resemble those prepared in conformity with U.S. standards. When the auditor believes there is a risk of misunderstanding, he should identify the other country in the report.

.12 When the auditor uses the standard report of the other country, the auditor should comply with the reporting standards of that country. The auditor should recognize that the standard report used in another country, even when it appears similar to that used in the United States, may convey a different meaning and entail a different responsibility on the part of the auditor due to custom or culture. Use of a standard report of another country may also require the auditor to provide explicit or implicit assurance of statutory compliance or otherwise require understanding of local law. When using the auditor's standard report of another country, the auditor needs to understand applicable legal responsibilities, in addition to the auditing standards and the accounting principles generally accepted in the other country. Accordingly, depending on the nature and extent of the auditor's knowledge and experience, he should consider consulting with persons having expertise in the audit reporting practices of the other country to attain the understanding needed to issue that country's standard report.

.13 A U.S. entity that prepares financial statements in conformity with U.S. generally accepted accounting principles also may prepare financial statements in conformity with accounting principles generally accepted in another country for use outside the United States. In such circumstances, the auditor may report on the financial statements that are in conformity with accounting principles of the other country by following the guidance in paragraphs .09 and .10. The auditor may wish to include, in one or both of the reports, a statement that another report has been issued on the financial statements for the entity that have been prepared in accordance with accounting principles generally

accepted in another country. The auditor may also wish to reference any note describing significant differences between the accounting principles used and U.S. GAAP. An example of such a statement follows.

> We also have reported separately on the financial statements of International Company for the same period presented in accordance with accounting principles generally accepted in [*name of country*]. (The significant differences between the accounting principles accepted in [*name of country*] and those generally accepted in the United States are summarized in Note X.)

Use in the United States

.14 If the auditor is requested to report on the fair presentation of financial statements, prepared in conformity with the accounting principles generally accepted in another country, that will have more than limited distribution in the United States, he should use the U.S. standard form of report (see section 508, *Reports on Audited Financial Statements*, paragraph .08), modified as appropriate (see section 508.35–.57), because of departures from accounting principles generally accepted in the United States.[6] The auditor may also, in a separate paragraph to the report, express an opinion on whether the financial statements are presented in conformity with accounting principles generally accepted in another country.

.15 The auditor may also report on the same set of financial statements, prepared in conformity with accounting principles generally accepted in another country, that will have more than limited distribution in the United States by using both the standard report of the other country or a U.S.-style report (described in paragraph .09) for distribution outside the United States, and a U.S. form of report (described in paragraph .14) for distribution in the United States.

Effective Date

.16 This section is effective for audits of financial statements for periods beginning after July 31, 1986.

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[6] This section does not apply to reports on financial statements of U.S. subsidiaries of foreign registrants presented in SEC filings of foreign parent companies where the subsidiaries' financial statements have been prepared on the basis of accounting principles used by the parent company. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62.]

AU Section 9534

Reporting on Financial Statements Prepared for Use in Other Countries: Auditing Interpretations of Section 534

1. Financial Statements for General Use Only Outside of the United States in Accordance With International Accounting Standards and International Standards on Auditing

.01 *Question*—Section 534, *Reporting on Financial Statements Prepared for Use in Other Countries*, provides guidance for the independent auditor practicing in the United States who is engaged to report on the financial statements of a U.S. entity[1] for general use only outside of the United States in conformity with accounting principles generally accepted in another country. May an independent auditor practicing in the United States report on the financial statements of a U.S. entity presented in conformity with the International Accounting Standards for general use only outside of the United States?

.02 *Interpretation*—Yes. In these circumstances, the auditor should follow the guidance in section 534 in planning and performing the engagement.

.03 *Question*—If the financial statements are presented in conformity with the International Accounting Standards, may a U.S. auditor perform the audit in accordance with the International Standards on Auditing?

.04 *Interpretation*—Yes. In these circumstances, the auditor should follow the guidance in section 534 in planning and performing the engagement. Section 534 requires the U.S. auditor, in these circumstances, to comply with the general and fieldwork standards of U.S. generally accepted auditing standards as well as any additional requirements of the International Standards on Auditing. The auditor may use either a U.S.-style report (section 534.09) or the report form set forth in the International Standards on Auditing.

[Issue Date: May, 1996.]

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[1] A U.S. entity is an entity that is either organized or domiciled in the United States.

AU Section 543

Part of Audit Performed by Other Independent Auditors

Source: SAS No. 1, section 543; SAS No. 64; Auditing Standard No. 3; Auditing Standard No. 5; Auditing Standard Nos. 8–15.

See section 9543 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

.01 This section provides guidance on the professional judgments the independent auditor makes in deciding (*a*) whether he may serve as principal auditor and use 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 and (*b*) the form and content of the principal auditor's report in these circumstances.[1] Nothing in this section should be construed to require or imply that an auditor, in deciding whether he may properly serve as principal auditor without himself auditing particular subsidiaries, divisions, branches, components, or investments of his client, should make that decision on any basis other than his judgment regarding the professional considerations as discussed in paragraphs .02 and .10; nor should an auditor state or imply that a report that makes reference to another auditor is inferior in professional standing to a report without such a reference. [As modified, September 1981, by the Auditing Standards Board.]

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]

> Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs C8-C11 of Appendix C, *Special Reporting Situations*, of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, which provide direction with respect to opinions based, in part, on the report of another auditor in an audit of internal control over financial reporting.

[*The following note is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.*]

> 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*.

Principal Auditor's Course of Action

.02 The auditor considering whether he may serve as principal auditor may have performed all but a relatively minor portion of the work, or significant parts of the audit may have been performed by other auditors. In the latter

[1] Section 315 applies if an auditor uses the work of a predecessor auditor in expressing an opinion on financial statements.

case, he must decide whether his own participation is sufficient to enable him to serve as the principal auditor and to report as such on the financial statements. In deciding this question, the auditor should consider, among other things, the materiality of the portion of the financial statements he has audited in comparison with the portion audited by other auditors, the extent of his knowledge of the overall financial statements, and the importance of the components he audited in relation to the enterprise as a whole. [As modified, September 1981, by the Auditing Standards Board.]

.03 If the auditor decides that it is appropriate for him to serve as the principal auditor, he must then decide whether to make reference in his report[2] to the audit performed by another auditor. If the principal auditor decides to assume responsibility for the work of the other auditor insofar as that work relates to the principal auditor's expression of an opinion on the financial statements taken as a whole, no reference should be made to the other auditor's work or report. On the other hand, if the principal auditor decides not to assume that responsibility, his report should make reference to the audit of the other auditor and should indicate clearly the division of responsibility between himself and the other auditor in expressing his opinion on the financial statements. Regardless of the principal auditor's decision, the other auditor remains responsible for the performance of his own work and for his own report.

Decision Not to Make Reference

.04 If the principal auditor is able to satisfy himself as to the independence and professional reputation of the other auditor (see paragraph .10) and takes steps he considers appropriate to satisfy himself as to the audit performed by the other auditor (see paragraph .12), he may be able to express an opinion on the financial statements taken as a whole without making reference in his report to the audit of the other auditor. If the principal auditor decides to take this position, he should not state in his report that part of the audit was made by another auditor because to do so may cause a reader to misinterpret the degree of responsibility being assumed.

.05 Ordinarily, the principal auditor would be able to adopt this position when:

a. Part of the audit is performed by another independent auditor which is an associated or correspondent firm and whose work is acceptable to the principal auditor based on his knowledge of the professional standards and competence of that firm; or

b. The other auditor was retained by the principal auditor and the work was performed under the principal auditor's guidance and control; or

c. The principal auditor, whether or not he selected the other auditor, nevertheless takes steps he considers necessary to satisfy himself as to the audit performed by the other auditor and accordingly is satisfied as to the reasonableness of the accounts for the purpose of inclusion in the financial statements on which he is expressing his opinion; or

d. The portion of the financial statements audited by the other auditor is not material to the financial statements covered by the principal auditor's opinion.

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[2] See paragraph .09 for example of appropriate reporting when reference is made to the audit of other auditors.

Decision to Make Reference

.06 On the other hand, the principal auditor may decide to make reference to the audit of the other auditor when he expresses his opinion on the financial statements. In some situations, it may be impracticable for the principal auditor to review the other auditor's work or to use other procedures which in the judgment of the principal auditor would be necessary for him to satisfy himself as to the audit performed by the other auditor. Also, if the financial statements of a component audited by another auditor are material in relation to the total, the principal auditor may decide, regardless of any other considerations, to make reference in his report to the audit of the other auditor.

.07 When the principal auditor decides that he will make reference to the audit of the other auditor, his report should indicate clearly, in both the introductory, scope and opinion paragraphs, the division of responsibility as between that portion of the financial statements covered by his own audit and that covered by the audit of the other auditor. The report should disclose the magnitude of the portion of the financial statements audited by the other auditor. This may be done by stating the dollar amounts or percentages of one or more of the following: total assets, total revenues, or other appropriate criteria, whichever most clearly reveals the portion of the financial statements audited by the other auditor. The other auditor may be named but only with his express permission and provided his report is presented together with that of the principal auditor.[3]

.08 Reference in the report of the principal auditor to the fact that part of the audit was made by another auditor is not to be construed as a qualification of the opinion but rather as an indication of the divided responsibility between the auditors who conducted the audits of various components of the overall financial statements. [As modified, September 1981, by the Auditing Standards Board.]

.09 An example of appropriate reporting by the principal auditor indicating the division of responsibility when he makes reference to the audit of the other auditor follows:

Independent Auditor's Report

> We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 20. . ., and the related consolidated statements of income and retained earnings and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets and revenues constituting 20 percent and 22 percent, respectively, of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.
>
> We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of the other auditors provide a reasonable basis for our opinion.

[3] As to filings with the Securities and Exchange Commission, see Rule 2-05 of Regulation S-X.

> In our opinion, based on our audit and the report of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20...., and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

When two or more auditors in addition to the principal auditor participate in the audit, the percentages covered by the other auditors may be stated in the aggregate. [Revised, April 1998, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

Procedures Applicable to Both Methods of Reporting

.10 Whether or not the principal auditor decides to make reference to the audit of the other auditor, he should make inquiries concerning the professional reputation and independence of the other auditor. He also should adopt appropriate measures to assure the coordination of his 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. These inquiries and other measures may include procedures such as the following:

a. Make inquiries as to the professional reputation and standing of the other auditor to one or more of the following:

(i) The American Institute of Certified Public Accountants,[4] the applicable state society of certified public accountants and/or the local chapter, or in the case of a foreign auditor, his corresponding professional organization.

(ii) Other practitioners.

(iii) Bankers and other credit grantors.

(iv) Other appropriate sources.

b. Obtain a representation from the other auditor that he is independent under the requirements of the American Institute of Certified Public Accountants and, if appropriate, the requirements of the Securities and Exchange Commission (SEC).[4a]

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[4] The AICPA Professional Ethics Division can respond to inquiries about whether individuals are members of the American Institute of Certified Public Accountants and whether complaints against members have been adjudicated by the Joint Trial Board. The division cannot respond to inquiries about public accounting firms or provide information about letters of required corrective action issued by the division or pending disciplinary proceedings or investigations. The AICPA Division for CPA Firms can respond to inquiries about whether specific public accounting firms are members of either the Private Companies Practice Section (PCPS) or the SEC Practice Section (SECPS), and can indicate whether a firm had a peer review in compliance with the Section's membership requirements and whether any sanctions against the firm have been publicly announced. In addition, the division will supply copies of peer-review reports that have been accepted by the applicable section of the division and information submitted by member firms on applications for membership and annual updates. The AICPA Practice Monitoring staff or the appropriate state CPA society can respond to inquiries as to whether specific public accounting firms are enrolled in the AICPA Peer Review Program and can indicate whether a firm had a peer review in compliance with the AICPA *Standards for Performing and Reporting on Peer Reviews* [PR section 100]. [As amended by the Auditing Standards Board, June 1990.]

[4a] [Footnote deleted, December 2001, to acknowledge the dissolution of the Independence Standard Board.]

c. Ascertain through communication with the other auditor:

(i) That he is aware that the financial statements of the component which he is to audit are to be included in the financial statements on which the principal auditor will report and that the other auditor's report thereon will be relied upon (and, where applicable, referred to) by the principal auditor.

(ii) That he or she is familiar with accounting principles generally accepted in the United States of America and with the generally accepted auditing standards promulgated by the American Institute of Certified Public Accountants and will conduct his or her audit and will report in accordance therewith.

(iii) That he has knowledge of the relevant financial reporting requirements for statements and schedules to be filed with regulatory agencies such as the Securities and Exchange Commission, if appropriate.

(iv) That a review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among the components included in the financial statements.

(Inquiries as to matters under *a*, and *c* (ii) and (iii) ordinarily would be unnecessary if the principal auditor already knows the professional reputation and standing of the other auditor and if the other auditor's primary place of practice is in the United States.) [As modified, September 1981, by the Auditing Standards Board. Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

.11 If the results of inquiries and procedures by the principal auditor with respect to matters described in paragraph .10 lead him to the conclusion that he can neither assume responsibility for the work of the other auditor insofar as that work relates to the principal auditor's expression of an opinion on the financial statements taken as a whole, nor report in the manner set forth in paragraph .09, he should appropriately qualify his opinion or disclaim an opinion on the financial statements taken as a whole. His reasons therefor should be stated, and the magnitude of the portion of the financial statements to which his qualification extends should be disclosed.

Additional Procedures Under Decision Not to Make Reference

.12 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

When the principal auditor decides not to make reference to the audit of the other auditor, in addition to satisfying himself as to the matters described in AU sec. 543.10, the principal auditor must obtain, and review and retain, the following information from the other auditor:

a. An engagement completion document consistent with paragraphs 12 and 13 of PCAOB Auditing Standard No. 3.

Note: This engagement completion document should include all cross-referenced, supporting audit documentation.

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

c. Sufficient information relating to significant findings or issues that are inconsistent with or contradict the auditor's final conclusions, as described in paragraph 8 of PCAOB Auditing Standard No. 3.

d. Any findings affecting the consolidating or combining of accounts in the consolidated financial statements.

e. Sufficient information to enable the office issuing the auditor's report to agree or reconcile the financial statement amounts audited by the other firm to the information underlying the consolidated financial statements.

f. 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.

g. All significant deficiencies and material weaknesses in internal control over financial reporting, including a clear distinction between those two categories.

h. Letters of representations from management.

i. All matters to be communicated to the audit committee.

The principal auditor must obtain, and review and retain, such documents prior to the report release date.[5] In addition, the principal auditor should consider performing one or more of the following procedures:

- Visit the other auditor and discuss the audit procedures followed and results thereof.
- Review the audit programs of the other auditor. In some cases, it may be appropriate to issue instructions to the other auditor as to the scope of the audit work.
- Review additional audit documentation of the other auditor relating to significant findings or issues in the engagement completion document.

.13 In some circumstances the principal auditor may consider it appropriate to participate in discussions regarding the accounts with management personnel of the component whose financial statements are being audited by other auditors and/or to make supplemental tests of such accounts. The determination of the extent of additional procedures, if any, to be applied rests with the principal auditor alone in the exercise of his professional judgment and in no way constitutes a reflection on the adequacy of the other auditor's work. Because the principal auditor in this case assumes responsibility for his opinion on the financial statements on which he is reporting without making reference to the audit performed by the other auditor, his judgment must govern as to the extent of procedures to be undertaken.

Long-Term Investments

.14 With respect to investments accounted for under the equity method, the auditor who uses another auditor's report for the purpose of reporting on

[5] As it relates to the direction in paragraph .19 of AU sec. 324, for the auditor to "give consideration to the guidance in section 543.12," the auditor need not, in this circumstance, obtain the previously enumerated documents.

the investor's equity in underlying net assets and its share of earnings or losses and other transactions of the investee is in the position of a principal auditor using the work and reports of other auditors. Under these circumstances, the auditor may decide that it would be appropriate to refer to the work and report of the other auditor in his report on the financial statements of the investor. (See paragraphs .06-.11.) When the work and reports of other auditors constitute a major element of evidence with respect to investments accounted for under the cost method, the auditor may be in a position analogous to that of a principal auditor.

Other Auditor's Report Departs From Standard Report

.15 If the report of the other auditor is other than a standard report, the principal auditor should decide whether the reason for the departure from the standard report is of such nature and significance in relation to the financial statements on which the principal auditor is reporting that it would require recognition in his own report. If the reason for the departure is not material in relation to such financial statements and the other auditor's report is not presented, the principal auditor need not make reference in his report to such departure. If the other auditor's report is presented, the principal auditor may wish to make reference to such departure and its disposition.

Restated Financial Statements of Prior Years Following a Pooling of Interests

.16 Following a pooling-of-interests transaction, an auditor may be asked to report on restated financial statements for one or more prior years when other auditors have audited one or more of the entities included in such financial statements. In some of these situations the auditor may decide that he has not audited a sufficient portion of the financial statements for such prior year or years to enable him to serve as principal auditor (see paragraph .02). Also, in such cases, it often is not possible or it may not be appropriate or necessary for the auditor to satisfy himself with respect to the restated financial statements. In these circumstances it may be appropriate for him to express his opinion solely with respect to the combining of such statements; however, no opinion should be expressed unless the auditor has audited the statements of at least one of the entities included in the restatement for at least the latest period presented. The following is an illustration of appropriate reporting on such combination that can be presented in an additional paragraph of the auditor's report following the standard introductory, scope and opinion paragraphs covering the consolidated financial statements for the current year:*

> We previously audited and reported on the consolidated statements of income and cash flows of XYZ Company and subsidiaries for the year ended December 31, 19X1, prior to their restatement for the 19X2 pooling of interests. The contribution of XYZ Company and subsidiaries to revenues and net income represented. . . . . percent and. . . . . percent of the respective restated totals. Separate financial statements of the other companies included in the 19X1 restated consolidated statements of income and cash flows were audited and reported on separately by other auditors. We also audited the combination of the accompanying consolidated statements of income and cash flows for the year ended December 31, 19X1, after restatement for the 19X2 pooling of interests;

* If restated consolidated balance sheets are also presented, the auditor may also express his opinion with respect to the combination of the consolidated balance sheets.

in our opinion, such consolidated statements have been properly combined on the basis described in Note A of notes to consolidated financial statements.

[As modified, October 1980, by the Auditing Standards Board. As amended, effective for reports issued after December 31, 1990, by Statement on Auditing Standards No. 64.]

.17 In reporting on restated financial statements as described in the preceding paragraph, the auditor does not assume responsibility for the work of other auditors nor the responsibility for expressing an opinion on the restated financial statements taken as a whole. He should apply procedures which will enable him to express an opinion only as to proper combination of the financial statements. These procedures include testing the combination for clerical accuracy and the methods used to combine the restated financial statements for conformity with generally accepted accounting principles. For example, the auditor should make inquiries and apply procedures regarding such matters as the following:

a. Elimination of intercompany transactions and accounts.

b. Combining adjustments and reclassifications.

c. Adjustments to treat like items in a comparable manner, if appropriate.

d. The manner and extent of presentation of disclosure matters in the restated financial statements and notes thereto.

The auditor should also consider the application of procedures contained in paragraph .10.

[As modified, October 1980, by the Auditing Standards Board.]

Predecessor Auditor

[.18] [Superseded by Statement on Auditing Standards No. 7, effective November 30, 1975, as superseded by Statement on Auditing Standards No. 84, effective with respect to acceptance of an engagement after March 31, 1998.] (See section 315.)

AU Section 9543

Part of Audit Performed by Other Independent Auditors: Auditing Interpretations of Section 543

Source: Auditing Standard Nos. 8–15.

1. Specific Procedures Performed by the Other Auditor at the Principal Auditor's Request

.01 *Question*—An independent auditor is auditing the financial statements of a component[1] in accordance with generally accepted auditing standards and is issuing a report to his client that will also be used by another independent auditor who is acting as a principal auditor.[2] The principal auditor requests the other auditor to perform specific procedures, for example, to furnish or test amounts to be eliminated in consolidation, such as intercompany profits, or to read other information in documents containing audited financial statements. In those circumstances, who is responsible to determine the extent of the procedures to be performed?

.02 *Interpretation*—Section 543, *Part of Audit Performed by Other Independent Auditors*, paragraph .10, states that the principal auditor "should adopt appropriate measures to assure the coordination of his 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." Section 543.10*c*(iv) further states that those measures may include procedures such as ascertaining through communication with the other auditor "that a review will be made of matters affecting elimination of intercompany transactions and accounts."

.03 Thus, when the principal auditor requests the other auditor to perform procedures, the principal auditor is responsible for determining the extent of the procedures to be performed. The principal auditor should provide specific instructions on procedures to be performed, materiality considerations for that purpose, and other information that may be necessary in the circumstances. The other auditor should perform the requested procedures in accordance with the principal auditor's instructions and report the findings solely for the use of the principal auditor.

[Issue Date: April, 1979; Revised: November 1996.]

2. Inquiries of the Principal Auditor by the Other Auditor

.04 *Question*—Section 543, *Part of Audit Performed by Other Independent Auditors*, gives guidance to a principal auditor on making inquiries of the other auditor. Section 543.03 also states that "the other auditor remains responsible for the performance of his own work and for his own report." Should the other auditor also make inquiries of the principal auditor to fulfill that responsibility?

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[1] For the purposes of this interpretation, the entities whose separate financial statements collectively comprise the consolidated or other financial statements are referred to as components.

[2] See section 543 for the definition of a principal auditor. For the purposes of this interpretation, the auditor whose work is used by a principal auditor is referred to as the other auditor.

.05 *Interpretation*—Section 334, *Related Parties*, states that there may be inquiry of the principal auditor regarding related parties. In addition, before issuing his report, the other auditor should consider whether he should inquire of the principal auditor as to matters that may be significant to his own audit.

.06 The other auditor's consideration of whether to make the inquiry should be based on factors such as his awareness that there are transactions or relationships which are unusual or complex between the component he is auditing and the component the principal auditor is auditing, or his knowledge that in the past matters relating to his audit have arisen that were known to the principal auditor but not to him.

.07 If the other auditor believes inquiry is appropriate he may furnish the principal auditor with a draft of the financial statements expected to be issued and of his report solely for the purpose of aiding the principal auditor to respond to the inquiry. The inquiry would concern transactions, adjustments, or other matters that have come to the principal auditor's attention that he believes require adjustment to or disclosure in the financial statements of the component being audited by the other auditor. Also, the other auditor should inquire about any relevant limitation on the scope of the audit performed by the principal auditor.

[Issue Date: April, 1979.]

3. Form of Inquiries of the Principal Auditor Made by the Other Auditor

.08 *Question*—In those circumstances when the other auditor believes an inquiry of the principal auditor is appropriate, what form should the inquiry take and when should it be made?

.09 *Interpretation*—The other auditor's inquiry ordinarily should be in writing. It should indicate whether the response should be in writing, and should specify the date as of which the principal auditor should respond. Ordinarily, that date should be near the anticipated date of the other auditor's report. An example of a written inquiry from the other auditor is as follows:

> "We are auditing the financial statements of (name of client) as of (date) and for the (period of audit) for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of (name of client) in conformity with generally accepted accounting principles.
>
> A draft of the financial statements referred to above and a draft of our report are enclosed solely to aid you in responding to this inquiry. Please provide us (in writing) (orally) with the following information in connection with your current examination of the consolidated financial statements of (name of parent company):
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> 1. Transactions or other matters (including adjustments made during consolidation or contemplated at the date of your reply) that have come to your attention that you believe require adjustment to or disclosure in the financial statements of (name of client) being audited by us.
> 2. Any limitation on the scope of your audit that is related to the financial statements of (name of client) being audited by us, or that limits your ability to provide us with the information requested in this inquiry.
>
> Please make your response as of a date near (expected date of the other auditor's report)."

.10 The principal auditor's reply will often be made as of a date when his audit is still in progress; however, the other auditor should expect that ordinarily the response should satisfy his need for information. However, there may be instances when the principal auditor's response explains that it is limited because his audit has not progressed to a point that enables him to provide a response that satisfies the other auditor's need for information. If the principal auditor's response is limited in that manner, the other auditor should consider whether to apply acceptable alternative procedures, delay the issuance of his report until the principal auditor can respond, or qualify his opinion or disclaim an opinion for a limitation on the scope of his audit.

[Issue Date: April, 1979]

4. Form of Principal Auditor's Response to Inquiries from Other Auditors

.11 *Question*—An independent auditor acting in the capacity of a principal auditor may receive an inquiry from another independent auditor performing the audit of the financial statements of a component concerning transactions, adjustments, or limitations on his audit.[3] What should be the form of the principal auditor's response?

.12 *Interpretation*—The principal auditor should respond promptly to the other auditor's inquiry, based on his audit, and if applicable, on his reading of the draft financial statements and report furnished by the other auditor. His response may be written or oral, as requested by the other auditor. However, the principal auditor's response ordinarily should be in writing if it contains information that may have a significant effect on the other auditor's audit.

.13 The principal auditor should identify the stage of completion of his audit as of the date of his reply. He should also indicate that no audit procedures were performed for the purpose of identifying matters that would not affect his audit and report, and therefore, not all the information requested would necessarily be revealed. If the principal auditor has been furnished with a draft of the financial statements being audited by the other auditor and a draft of his report, the principal auditor should state that he has read the draft only to aid him in making his reply.

.14 An example of a written response from the principal auditor is as follows:

> "This letter is furnished to you in response to your request that we provide you with certain information in connection with your audit of the financial statements of (name of component), a (subsidiary, division, branch or investment) of Parent Company for the year ended (date).
>
> We are in the process of performing an audit of the consolidated financial statements of Parent Company for the year ended (date) (but have not completed our work as of this date). The objective of our audit is to enable us to express an opinion on the consolidated financial statements of Parent Company and, accordingly, we have performed no procedures directed toward identifying matters that would not affect our audit or our report. However, solely for the purpose of responding to your inquiry, we have read the draft of the financial statements of (name of component) as of (date) and for the (period of audit) and the draft of your report on them, included with your inquiry dated (date of inquiry).

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[3] See section 9543.04–.07, "Inquiries of the Principal Auditor by the Other Auditor," above.

Based solely on the work we have performed (to date) in connection with our audit of the consolidated financial statements, which would not necessarily reveal all or any of the matters covered in your inquiry, we advise you that:

1. No transactions or other matters (including adjustments made during consolidation or contemplated at this date) have come to our attention that we believe require adjustment to or disclosure in the financial statements of (name of component) being audited by you.
2. No limitation has been placed by Parent Company on the scope of our audit that, to our knowledge, is related to the financial statements of (name of component) being audited by you, that has limited our ability to provide you with the information requested in your inquiry."

[Issue Date: April, 1979.]

5. Procedures of the Principal Auditor

.15 *Question*—What steps, if any, should the principal auditor take in responding to an inquiry such as that described in section 9543.11?

.16 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*[4]

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.

.17 If between the date of his response and the completion of his audit, the principal auditor becomes aware of information that he would have included in his response to the other auditor's inquiry had he been aware of it, the principal auditor should promptly communicate such information to the other auditor.[5]

[Issue Date: April, 1979.]

6. Application of Additional Procedures Concerning the Audit Performed by the Other Auditor

.18 *Question*—If a principal auditor decides not to make reference to the audit of another auditor, section 543 requires him to consider whether to apply procedures to obtain information about the adequacy of the audit performed by the other auditor. In making a decision about (*a*) whether to apply one or more of the procedures listed in section 543.12 and (*b*), if applicable, the extent of those procedures, may the principal auditor consider his knowledge of the other auditor's compliance with quality control policies and procedures?

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[4] *[Footnote 4 deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[5] See section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, concerning procedures to be followed by the other auditor if he receives the information after the issuance of his report.

.19 *Interpretation*—Yes. The principal auditor's judgment about the extent of additional procedures, if any, to be applied in the circumstances may be affected by various factors including his knowledge of the other auditor's quality control policies and procedures that provide the other auditor with reasonable assurance of conformity with generally accepted auditing standards in his audit engagements.

.20 Other factors that the principal auditor may wish to consider in making that decision include his previous experience with the other auditor, the materiality of the portion of the financial statements audited by the other auditor, the control exercised by the principal auditor over the conduct of the audit performed by the other auditor, and the results of the principal auditor's other procedures that may indicate whether additional evidential matter is necessary.

[Issue Date: December, 1981.]

[7.] Reporting on Financial Statements Presented on a Comprehensive Annual Financial Report of a Governmental Entity When One Fund Has Been Audited by Another Auditor

[.21–.24] [Withdrawn December, 1992 by the Audit Issues Task Force.][6],[7]

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[6] [Footnote deleted.]

[7] [Footnote deleted.]

AU Section 544

Lack of Conformity With Generally Accepted Accounting Principles

Source: SAS No. 1, section 544; SAS No. 2; SAS No. 62; SAS No. 77.

Issue date, unless otherwise indicated: November, 1972.

[.01] [Superseded by Statement on Auditing Standards No. 2, effective December 31, 1974.]

Regulated Companies

.02 The basic postulates and broad principles of accounting comprehended in the term "generally accepted accounting principles" which pertain to business enterprises in general apply also to companies whose accounting practices are prescribed by governmental regulatory authorities or commissions. (For example, public utilities and insurance companies.) Accordingly, the first reporting standard is equally applicable to opinions on financial statements of such regulated companies presented for purposes other than filings with their respective supervisory agencies; and material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated.[1] Ordinarily, this will require either a qualified or an adverse opinion on such statements. An adverse opinion may be accompanied by an opinion on supplementary data which are presented in conformity with generally accepted accounting principles. [As amended, effective periods ending on or after December 31, 1974, by Statement on Auditing Standards No. 2. As amended by Statement on Auditing Standards No. 62, effective for reports issued on or after July 1, 1989.]

.03 It should be recognized, however, that appropriate differences exist with respect to the application of generally accepted accounting principles as between regulated and nonregulated businesses because of the effect in regulated businesses of the rate-making process, a phenomenon not present in nonregulated businesses (FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulations* [AC section Re6]). Such differences usually concern mainly the time at which various items enter into the determination of net income in accordance with the principle of matching costs and revenues.

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[1] When reporting on financial statements of a regulated entity that are prepared in accordance with the requirements of financial reporting provisions of a government regulatory agency to whose jurisdiction the entity is subject, the auditor may report on the financial statements as being prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles (see section 623, *Special Reports,* paragraphs .02 and .10). Reports of this nature, however, should be issued only if the financial statements are intended solely for filing with one or more regulatory agencies to whose jurisdiction the entity is subject. [As amended, effective for audits of financial statements for periods ended on or after December 31, 1996, by Statement on Auditing Standards No. 77.]

It should also be recognized that accounting requirements not directly related to the rate-making process commonly are imposed on regulated businesses and that the imposition of such accounting requirements does not necessarily mean that they conform with generally accepted accounting principles.

.04 When financial statements of a regulated entity are prepared in accordance with a basis of accounting prescribed by one or more regulatory agencies or the financial reporting provisions of another agency, the independent auditor may also be requested to report on their fair presentation in conformity with such prescribed basis of accounting in presentations for distribution in other than filings with the entity's regulatory agency. In those circumstances, the auditor should use the standard form of report (see section 508, *Reports on Audited Financial Statements*, paragraph .08), modified as appropriate (see section 508.35-.60) because of the departures from generally accepted accounting principles, and then, in an additional paragraph to the report, express an opinion on whether the financial statements are presented in conformity with the prescribed basis of accounting. [As amended by Statement on Auditing Standards No. 62, effective for reports issued on or after July 1, 1989. As amended, effective for audits of financial statements for periods ended on or after December 31, 1996, by Statement on Auditing Standards No. 77.]

AU Section 550

Other Information in Documents Containing Audited Financial Statements

Source: SAS No. 8; SAS No. 98; Auditing Standard No. 16.

See section 9550 for interpretations of this section.

Issue date, unless otherwise indicated: December, 1975.

.01 An entity may publish various documents that contain information (hereinafter, "other information") in addition to audited financial statements and the independent auditor's report thereon. This section provides guidance for the auditor's consideration of other information included in such documents.

.02 This section is applicable only to other information contained in (*a*) annual reports to holders of securities or beneficial interests, annual reports of organizations for charitable or philanthropic purposes distributed to the public, and annual reports filed with regulatory authorities under the Securities Exchange Act of 1934 or (*b*) other documents to which the auditor, at the client's request, devotes attention.

.03 This section is not applicable when the financial statements and report appear in a registration statement filed under the Securities Act of 1933. The auditor's procedures with respect to 1933 Act filings are unaltered by this section (see sections 634[†] and 711[††]). Also, this section is not applicable to other information on which the auditor is engaged to express an opinion.[1] The guidance applicable to auditing and reporting on certain information other than financial statements intended to be presented in conformity with generally accepted accounting principles is unaltered by this section (see sections 551[*] and 623[**]).

.04 *[The following paragraph is effective for audits of fiscal years ending on or after December 15, 2012. See PCAOB Release 2012-004.]*

Other information in a document may be relevant to an audit performed by an independent auditor or to the continuing propriety of his report. The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial

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[†] [Section 631, formerly 630, changed by the issuance of Statement on Auditing Standards No. 38 (superseded). Section 634, formerly 631, changed by the issuance of Statement on Auditing Standards No. 49.] (See section 634.)

[††] [Section number revised, April 1981, by the issuance of Statement on Auditing Standards No. 37.] (See section 711.)

[1] Mere reading of other information is an inadequate basis for expressing an opinion on that information.

[*] [Section number revised, July 1980, by the issuance of Statement on Auditing Standards No. 29.] (See section 551.)

[**] [Section number changed, April 1989, by the issuance of Statement on Auditing Standards No. 62.] (See section 623.)

statements.[2] If the auditor concludes that there is a material inconsistency, he should determine whether the financial statements, his report, or both require revision. If he concludes that they do not require revision, he should request the client to revise the other information. If the other information is not revised to eliminate the material inconsistency, he should communicate the material inconsistency to the audit committee and consider other actions, such as revising his report to include an explanatory paragraph describing the material inconsistency, withholding the use of his report in the document, and withdrawing from the engagement. The action he takes will depend on the particular circumstances and the significance of the inconsistency in the other information.

.05 If, while reading the other information for the reasons set forth in paragraph .04, the auditor becomes aware of information that he believes is a material misstatement of fact that is not a material inconsistency as described in paragraph .04, he should discuss the matter with the client. In connection with this discussion, the auditor should consider that he may not have the expertise to assess the validity of the statement, that there may be no standards by which to assess its presentation, and that there may be valid differences of judgment or opinion. If the auditor concludes he has a valid basis for concern he should propose that the client consult with some other party whose advice might be useful to the client, such as the client's legal counsel.

.06 *[The following paragraph is effective for audits of fiscal years ending on or after December 15, 2012. See PCAOB Release 2012-004.]*

If, after discussing the matter as described in paragraph .05, the auditor concludes that a material misstatement of fact remains, the action he takes will depend on his judgment in the particular circumstances. He should communicate the material misstatement of fact to the client and the audit committee, in writing, and consider consulting his legal counsel as to further appropriate action in the circumstances.

.07 If certain other information[3] has been subjected to auditing procedures applied in the audit of the basic financial statements, the auditor may express an opinion on whether the information is fairly stated in all material respects in relation to those financial statements taken as a whole. In those circumstances, the auditor's report on the information should describe clearly the character of the auditor's work and the degree of responsibility the auditor is taking. The auditor may report on such information using the guidance in section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, paragraphs .12 and .14. [Paragraph added, effective September 2002, by Statement on Auditing Standards No. 98.]

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[2] In fulfilling his responsibility under this section, a principal auditor may also request the other auditor or auditors involved in the engagement to read the other information. If a predecessor auditor's report appears in a document to which this section applies, he should read the other information for the reasons described in this paragraph.

[3] This information may include supplementary information required by generally accepted accounting principles. [Footnote added, effective September 2002, by Statement on Auditing Standards No. 98.]

AU Section 9550

Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550

[1.] Reports by Management on Internal Accounting Control[1-4]

[.01–.06] [Superseded May, 1994 by Interpretation Nos. 2 and 3, paragraphs .07–.15.]

2. Reports by Management on Internal Control Over Financial Reporting

.07 *Question*—Communications to various parties specified in section 550, *Other Information in Documents Containing Audited Financial Statements*, paragraph .02 may include a separate report by management containing an assertion about the effectiveness of the entity's internal control over financial reporting. What is the auditor's responsibility concerning such report?

.08 *Interpretation*—If the auditor has been engaged to examine and report on management's assertion, the guidance in AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*, should be followed.

.09 If the auditor has not been engaged to examine and report on management's assertion, the auditor should follow the guidance in section 550, which states that "the auditor has no obligation to perform any procedures to corroborate other information contained in [such] a document." Under section 550, the auditor is required to read the report by management and consider whether it is materially inconsistent with information appearing in the financial statements and, as a result, he or she may become aware of a material misstatement of fact.[5]

.10 Although not required, the auditor may consider adding the following paragraph to the standard auditor's report: "We were not engaged to examine management's assertion about the effectiveness of [*name of entity's*] internal control over financial reporting as of [*date*] included in the accompanying [*title of management's report*] and, accordingly, we do not express an opinion thereon."

.11 Because an auditor is required to consider internal control in an audit of the financial statements, he or she would often be familiar with matters covered in a management report on internal control over financial reporting. As a result, the auditor may become aware of information that causes him or her to believe that management's assertion on the effectiveness of internal control

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[1-4] [Superseded May, 1994 by Interpretation Nos. 2 and 3, paragraphs .07-.15.]

[5] Unless information on internal control over financial reporting appears in the financial statements, which is not common, a management assertion on the effectiveness of internal control over financial reporting could not be inconsistent with information appearing in financial statements.

over financial reporting contains a material misstatement of fact as described in section 550.[6] If the auditor becomes aware of information in the report by management that conflicts with his or her knowledge or understanding of such matters, he or she should discuss the information with the client. If, after discussions with the client, the auditor concludes that a material misstatement of fact exists, the auditor should follow the guidance in section 550.06.

[Issue Date: May, 1994; Revised: January, 2001.]

3. Other References by Management to Internal Control Over Financial Reporting, Including References to the Independent Auditor

.12 *Question*—Communications to various parties specified in section 550, *Other Information in Documents Containing Audited Financial Statements*, paragraph .02 may include a statement by management about the entity's internal control over financial reporting. Such documents may also refer to the independent auditor in circumstances other than when the auditor has been engaged to examine and report on management's assertion about the effectiveness of internal control over financial reporting. What is the auditor's responsibility in such circumstances?

.13 *Interpretation*—The auditor should follow the guidance in section 550, which states that "the auditor has no obligation to perform any procedures to corroborate other information contained in [such] a document." Under section 550, the auditor is required to read other information in documents containing audited financial statements and consider whether it is materially inconsistent with information appearing in the financial statements and, as a result, he or she may become aware of a material misstatement of fact. If the auditor becomes aware of information in the report by management that conflicts with his or her knowledge or understanding of such matters, he or she should discuss the information with the client. If, after discussions with the client, the auditor concludes that a material misstatement of fact exists, the auditor should follow the guidance in section 550.06.

.14 Generally, management may discuss its responsibility for internal control over financial reporting and report on its effectiveness. In reading such information, the auditor should evaluate specific references by management that deal with the auditor's consideration of internal control in planning and performing the audit of the financial statements, particularly if such reference would lead the reader to assume the auditor had performed more work than required under generally accepted auditing standards or would lead the reader to believe that the auditor was giving assurances on internal control. The auditor should also consider whether management's comment or statement uses the auditor's name in such a way as to indicate or imply that the auditor's involvement is greater than is supported by the facts.[7] If management misstates

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[6] For example, the auditor has communicated to management a material weakness in internal control over financial reporting and management states or implies there are no material weaknesses.

[7] For instance, management may report that "X Company's external auditors have reviewed the company's internal control in connection with their audit of the financial statements." Because AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*, prohibits an engagement to review and report on the effectiveness of the entity's internal control over financial reporting or a written assertion thereon, a statement by management that the auditors had "reviewed" the company's internal control would be inappropriate.

the auditor's responsibility for consideration of internal control over financial reporting, the auditor should discuss the matter with the client and consider whether any further action is needed in accordance with section 550.06.

.15 The auditing interpretation of section 325, *Communication of Internal Control Related Matters Noted in an Audit*, titled "Reporting on the Existence of Material Weaknesses" (section 9325.01-.07), permits an auditor to report to management that he or she has not become aware of any material weaknesses[8] during his or her audit of the financial statements, but requires such reports to be solely for the information and use of the entity's audit committee, management and others within the organization. If, however, management decides to include or refer to this communication in a general use document, the auditor should communicate to management the restrictions on use of the communication and the potential for such a statement to be misunderstood. For example, the fact that an audit has not disclosed any material weaknesses does not necessarily mean none exist since an audit of the financial statements does not constitute an examination of a management assertion about the effectiveness of internal control over financial reporting. If management refuses to make appropriate changes to the report, the auditor should advise management that he or she has not consented to the use of his or her name and should consider what other actions might be appropriate. In considering what actions, if any, may be appropriate in the circumstances, the auditor may wish to consult legal counsel.

[Issue Date: May, 1994; Revised: January, 2001.]

4. Other Information in Electronic Sites Containing Audited Financial Statements

.16 *Question*—An entity may make information available in public computer networks, such as the World Wide Web area of the Internet, an electronic bulletin board, the Securities and Exchange Commission's EDGAR system, or similar electronic venues (hereinafter, "electronic sites"). Information in electronic sites may include annual reports to shareholders, financial statements and other financial information, as well as press releases, product information and promotional material. When audited financial statements and the independent auditor's report thereon are included in an electronic site, what is the auditor's responsibility with respect to other information included in the electronic site?

.17 *Interpretation*—Electronic sites are a means of distributing information and are not "documents," as that term is used in section 550, *Other Information in Documents Containing Audited Financial Statements*. Thus, auditors are not required by section 550 to read information contained in electronic sites, or to consider the consistency of other information (as that term is used in section 550) in electronic sites with the original documents.

.18 Auditors may be asked by their clients to render professional services with respect to information in electronic sites. Such services, which might take

[8] Section 325.08 prohibits a written communication that no significant deficiencies were noted during the audit. If management reports that an auditor made an oral communication that no significant deficiencies were noted during the audit, the auditor should follow the guidance in this paragraph.

different forms, are not contemplated by section 550. Other auditing or attestation standards may apply, for example, agreed-upon procedures pursuant to AT section 201, *Agreed-Upon Procedures Engagements*, depending on the nature of the service requested.

[Issue Date: March, 1997; Revised: January, 2001.]

AU Section 551

Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents

(Supersedes section 610, "Long-Form Reports")[1]

Source: SAS No. 29; SAS No. 52; SAS No. 98.

Effective for auditors' reports dated on or after December 31, 1980, unless otherwise indicated.

.01 This section provides guidance on the form and content of reporting when an auditor submits to his client or to others a document that contains information in addition to the client's basic financial statements and the auditor's report thereon.

.02 The auditor's standard report covers the basic financial statements: balance sheet, statement of income, statement of retained earnings or changes in stockholders' equity, and statement of cash flows. The following presentations are considered part of the basic financial statements: descriptions of accounting policies, notes to financial statements, and schedules and explanatory material that are identified as being part of the basic financial statements. For purposes of this section, basic financial statements also include an individual basic financial statement, such as a balance sheet or statement of income and financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.

.03 The information covered by this section is presented outside the basic financial statements and is not considered necessary for presentation of financial position, results of operations, or cash flows in conformity with generally accepted accounting principles. Such information includes additional details or explanations of items in or related to the basic financial statements, consolidating information, historical summaries of items extracted from the basic financial statements, statistical data, and other material, some of which may be from sources outside the accounting system or outside the entity.

Reporting Responsibility

.04 When an auditor submits a document containing audited financial statements to his client or to others, he has a responsibility to report on all the information included in the document. On the other hand, when the auditor's report is included in a client-prepared document[2] and the auditor is not engaged to report on information accompanying the basic financial statements, his responsibility with respect to such information is described in (*a*) section 550, *Other*

[1] This section also supersedes the March 1979 auditing interpretation, "Reports on Consolidated Financial Statements That Include Supplementary Consolidating Information".

[2] Client-prepared documents include financial reports prepared by the client but merely reproduced by the auditor on the client's behalf.

Information in Documents Containing Audited Financial Statements, and (*b*) other sections covering particular types of information or circumstances, such as section 558, *Required Supplementary Information*.

.05 An auditor's report on information accompanying the basic financial statements in an auditor-submitted document has the same objective as an auditor's report on the basic financial statements: to describe clearly the character of the auditor's work and the degree of responsibility the auditor is taking. Although the auditor may participate in the preparation of the accompanying information as well as the basic financial statements, both the statements and the accompanying information are representations of management.

.06 The following guidelines apply to an auditor's report on information accompanying the basic financial statements in an auditor-submitted document:

a. The report should state that the audit has been performed for the purpose of forming an opinion on the basic financial statements taken as a whole.

b. The report should identify the accompanying information. (Identification may be by descriptive title or page number of the document.)

c. The report should state that the accompanying information is presented for purposes of additional analysis and is not a required part of the basic financial statements.[3]

d. The report should include either an opinion on whether the accompanying information is fairly stated in all material respects in relation to the basic financial statements taken as a whole or a disclaimer of opinion, depending on whether the information has been subjected to the auditing procedures applied in the audit of the basic financial statements. The auditor may express an opinion on a portion of the accompanying information and disclaim an opinion on the remainder.

e. The report on the accompanying information may be added to the auditor's report on the basic financial statements or may appear separately in the auditor-submitted document.

.07 The purpose of an audit of basic financial statements in accordance with generally accepted auditing standards is to form an opinion on those statements taken as a whole. Nevertheless, an audit of basic financial statements often encompasses information accompanying those statements in an auditor-submitted document. Also, although an auditor has no obligation to apply auditing procedures to information presented outside the basic financial statements, he may choose to modify or redirect certain of the procedures to be applied in the audit of the basic financial statements so that he may express an opinion on the accompanying information in the manner described in paragraph .06.

.08 When reporting in this manner, the measurement of materiality is the same as that used in forming an opinion on the basic financial statements taken as a whole. Accordingly, the auditor need not apply procedures as extensive as would be necessary to express an opinion on the information taken by itself. Guidance applicable to the expression of an opinion on specified elements,

[3] The auditor may refer to any regulatory agency requirements applicable to the information presented.

accounts, or items of financial statements for the purpose of a separate presentation is provided in section 623.11–.18, *Special Reports*.

.09 If the auditor concludes, on the basis of facts known to him, that any accompanying information is materially misstated in relation to the basic financial statements taken as a whole, he should discuss the matter with the client and propose appropriate revision of the accompanying information.[4] If the client will not agree to revision of the accompanying information, the auditor should either modify his report on the accompanying information and describe the misstatement or refuse to include the information in the document.

.10 The auditor should consider the effect of any modifications in his standard report when reporting on accompanying information. When the auditor expresses a qualified opinion on the basic financial statements, he should make clear the effects upon any accompanying information as well (see paragraph .14). When the auditor expresses an adverse opinion, or disclaims an opinion, on the basic financial statements, he should not express the opinion described in paragraph .06 on any accompanying information.[5] An expression of such an opinion in these circumstances would be inappropriate because, like a piecemeal opinion, it may tend to overshadow or contradict the disclaimer of opinion or adverse opinion on the basic financial statements. (See section 508.64 and section 623.14.)

.11 A client may request that nonaccounting information and certain accounting information not directly related to the basic financial statements be included in an auditor-submitted document. Ordinarily, such information would not have been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, the auditor would disclaim an opinion on it. In some circumstances, however, such information may have been obtained or derived from accounting records that have been tested by the auditor (for example, number of units produced related to royalties under a license agreement or number of employees related to a given payroll period). Accordingly, the auditor may be in a position to express an opinion on such information in the manner described in paragraph .06.

Reporting Examples

.12 An example of reporting on information accompanying the basic financial statements in an auditor-submitted document follows:

> Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.[6]

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[4] See paragraph .10 for guidance when there is a modification of the auditor's standard report on the basic financial statements.

[5] The provisions of this paragraph do not change the guidance, concerning companies whose accounting practices are prescribed by governmental regulatory authorities or commissions, in the last sentence of section 544.02, "Regulated Companies," which reads: "An adverse opinion may be accompanied by an opinion on supplementary data which are presented in conformity with generally accepted accounting principles."

[6] [Footnote deleted by the issuance of Statement on Auditing Standards No. 98, September 2002.]

.13 When the auditor disclaims an opinion on all or part of the accompanying information in a document that he submits to his client or to others, such information should either be marked as unaudited or should include a reference to the auditor's disclaimer of opinion. The wording of the disclaimer will vary according to the circumstances. Two examples follow.

Disclaimer on All of the Information

> Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify the accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

Disclaimer on Part of the Information

> Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information on pages XX—YY is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information, except for that portion marked "unaudited," on which we express no opinion, has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

.14 An example follows of reporting on accompanying information to which a qualification in the auditor's report on the basic financial statements applies.

> Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The schedules of investments (page 7), property (page 8), and other assets (page 9) as of December 31, 19XX, are presented for purposes of additional analysis and are not a required part of the basic financial statements. The information in such schedules has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, except for the effects on the schedule of investments of not accounting for the investments in certain companies by the equity method as explained in the second preceding paragraph [second paragraph of our report on page 1], such information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Supplementary Information Required by GAAP

.15 When supplementary information required by GAAP is presented outside the basic financial statements in an auditor-submitted document, the auditor should (*a*) express an opinion on the information if the auditor has been engaged to examine the information, (*b*) report on the information using the guidance in paragraphs .12 and .14, provided such information has been subjected to the auditing procedures applied in the audit of the basic financial statements, or (*c*) disclaim an opinion on the information.[7] The following is an example of a disclaimer an auditor might use in these circumstances:

> The [*identify the supplementary information*] on page XX is not a required part of the basic financial statements but is supplementary information required by

[7] The guidance in subsection (*b*) of this paragraph applies to GASB required supplementary information, such as that required by GASB Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers*. The auditor should refer to section 552, *Reporting on Condensed Financial Statements and Selected Financial Data*, paragraphs .09–.10, for an example of a report on GASB required supplementary information.

accounting principles generally accepted in the United States of America.[8] We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

[As amended, effective April 1988, by Statement on Auditing Standards No. 52. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.16 The auditor's report should be expanded in accordance with section 558, *Required Supplementary Information*, paragraph .08, if (*a*) supplementary information that GAAP requires to be presented in the circumstances is omitted, (*b*) the auditor has concluded that the measurement or presentation of the supplementary information departs materially from guidelines prescribed by GAAP, (*c*) the auditor is unable to complete the procedures prescribed by section 558, or (*d*) the auditor is unable to remove substantial doubts about whether the supplementary information conforms to prescribed guidelines. [Paragraph added, effective September 2002, by Statement on Auditing Standards No. 98.]

Consolidating Information

.17 Consolidated financial statements may include consolidating information or consolidating schedules presenting separate financial statements of one or more components of the consolidated group.[9] In some cases, the auditor is engaged to express an opinion on the financial statements of the components as well as on the consolidated financial statements. In other cases, the auditor is engaged to express an opinion only on the consolidated financial statements but consolidating information or schedules accompany the basic consolidated financial statements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

.18 When the auditor is engaged to express an opinion only on the consolidated financial statements and consolidating information is also included, the auditor should be satisfied that the consolidating information is suitably identified. For example, when the consolidated financial statements include columns of information about the components of the consolidated group, the balance sheets might be titled, "Consolidated Balance Sheet—December 31, 19X1, with Consolidating Information," and the columns including the consolidating information might be marked, "Consolidating Information." When the consolidating information is presented in separate schedules, the schedules presenting balance sheet information of the components might be titled, for example, "Consolidating Schedule, Balance Sheet Information, December 31, 19X1." [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

.19 When the consolidated financial statements include consolidating information that has not been separately audited, the auditor's report on the consolidating information might read

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[8] The auditor may identify the body requiring the information, such as the Financial Accounting Standards Board or the Governmental Accounting Standards Board. [Footnote added, effective September 2002, by Statement on Auditing Standards No. 98.]

[9] This section [paragraphs .17–.20] is also applicable to combined and combining financial statements. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002. Footnote revised, September 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 98.]

> Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

.20 When the auditor is engaged to express an opinion on both the consolidated financial statements and the separate financial statements of the components presented in consolidating financial statements, the auditor's reporting responsibilities with respect to the separate financial statements are the same as his responsibilities with respect to the consolidated financial statements. In such cases, the consolidating financial statements and accompanying notes should include all the disclosures that would be necessary for presentation in conformity with generally accepted accounting principles of separate financial statements of each component. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

Additional Commentary Concerning the Audit

.21 The auditor may be requested to describe the procedures applied to specific items in the financial statements. Additional comments of this nature should not contradict or detract from the description of the scope of his audit in the standard report. Also, they should be set forth separately rather than interspersed with the information accompanying the basic financial statements to maintain a clear distinction between management's representations and the auditor's representations. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

Co-Existing Financial Statements

.22 More than one type of document containing the audited financial statements may exist. For example, the auditor may submit to his client or others a document containing the basic financial statements, other information, and his report thereon, and the client may issue a separate document containing only the basic financial statements and the auditor's report. The basic financial statements should include all the information considered necessary for presentation in conformity with generally accepted accounting principles in all co-existing documents. The auditor should be satisfied that information accompanying the basic financial statements in an auditor-submitted document would not support a contention that the basic financial statements in the other document were not presented in conformity with generally accepted accounting principles because of inadequate disclosure of material information known to the auditor. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

Effective Date

.23 This section will be effective for auditors' reports dated on or after December 31, 1980. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

AU Section 552

Reporting on Condensed Financial Statements and Selected Financial Data[*]

Source: SAS No. 42; SAS No. 71.

Effective for reports issued or reissued on or after January 1, 1989, on condensed financial statements or selected financial data unless otherwise indicated.

.01 This section provides guidance on reporting in a client-prepared document on—

a. Condensed financial statements (either for an annual or an interim period) that are derived from audited financial statements of a public entity[1] that is required to file, at least annually, complete audited financial statements with a regulatory agency.

b. Selected financial data that are derived from audited financial statements of either a public or a nonpublic entity and that are presented in a document that includes audited financial statements (or, with respect to a public entity, that incorporates audited financial statements by reference to information filed with a regulatory agency).

Guidance on reporting on condensed financial statements or selected financial data that accompany audited financial statements in an auditor-submitted document is provided in section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*.

.02 In reporting on condensed financial statements or selected financial data in circumstances other than those described in paragraph .01, the auditor should follow the guidance in section 508, *Reports on Audited Financial Statements*, paragraphs .41 through .44, section 623, *Special Reports*, or other applicable Statements on Auditing Standards.[2]

Condensed Financial Statements

.03 Condensed financial statements are presented in considerably less detail than complete financial statements that are intended to present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. For this reason, they should be read in conjunction with the entity's most recent complete financial statements that include all the disclosures required by generally accepted accounting principles.

.04 An auditor may be engaged to report on condensed financial statements that are derived from audited financial statements. Because condensed

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[*] This section has been revised to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62.

[1] *Public entity* is defined in section 504, *Association With Financial Statements*, footnote 2.

[2] An auditor who has audited and reported on complete financial statements of a nonpublic entity may subsequently be requested to compile financial statements for the same period that omit substantially all disclosures required by generally accepted accounting principles. Reporting on comparative financial statements in those circumstances is described in SSARS No. 2, paragraphs 29 and 30.

financial statements do not constitute a fair presentation of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles, an auditor should not report on condensed financial statements in the same manner as he reported on the complete financial statements from which they are derived. To do so might lead users to assume, erroneously, that the condensed financial statements include all the disclosures necessary for complete financial statements. For the same reason, it is desirable that the condensed financial statements be so marked.

.05 In the circumstances described in paragraph .01(*a*),[3] the auditor's report on condensed financial statements that are derived from financial statements that he has audited should indicate (*a*) that the auditor has audited and expressed an opinion on the complete financial statements, (*b*) the date of the auditor's report on the complete financial statements,[4] (*c*) the type of opinion expressed, and (*d*) whether, in the auditor's opinion, the information set forth in the condensed financial statements is fairly stated in all material respects in relation to the complete financial statements from which it has been derived.[5]

.06 The following is an example of wording that an auditor may use in the circumstances described in paragraph .01(*a*) to report on condensed financial statements that are derived from financial statements that he or she has audited and on which he or she has issued a standard report:

Independent Auditor's Report

> We have audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements.
>
> In our opinion, the information set forth in the accompanying condensed consolidated financial statements is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

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[3] SEC regulations require certain registrants to include in filings, as a supplementary schedule to the consolidated financial statements, condensed financial information of the parent company. The auditor should report on such condensed financial information in the same manner as he reports on other supplementary schedules.

[4] Reference to the date of the original report removes any implication that records, transactions, or events after that date have been examined. The auditor does not have a responsibility to investigate or inquire further into events that may have occurred during the period between the date of the report on the complete financial statements and the date of the report on the condensed financial statements. (However, see section 711, *Filings Under Federal Securities Statutes*, regarding the auditor's responsibility when his report is included in a registration statement filed under the Securities Act of 1933.)

[5] If the auditor's opinion on the complete financial statements was other than unqualified, the report should describe the nature of, and the reasons for, the qualification. The auditor should also consider the effect that any modification of the report on the complete financial statements might have on the report on the condensed financial statements or selected financial data. For example, if the auditor's report on the complete financial statements referred to another auditor or included an explanatory paragraph because of a material uncertainty, a going concern matter, or an inconsistency in the application of accounting principles, the report on the condensed financial statements should state that fact. However, no reference to the inconsistency is necessary if a change in accounting referred to in the auditor's report on the complete financial statements does not affect the comparability of the information being presented.

[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

.07 A client might make a statement in a client-prepared document that names the auditor and also states that condensed financial statements have been derived from audited financial statements. Such a statement does not, in itself, require the auditor to report on the condensed financial statements, provided that they are included in a document that contains audited financial statements (or that incorporates such statements by reference to information filed with a regulatory agency). However, if such a statement is made in a client-prepared document of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency and that document does not include audited financial statements (or does not incorporate such statements by reference to information filed with a regulatory agency),[6] the auditor should request that the client either (*a*) not include the auditor's name in the document or (*b*), include the auditor's report on the condensed financial statements, as described in paragraph .05. If the client will neither delete the reference to the auditor nor allow the appropriate report to be included, the auditor should advise the client that he does not consent to either the use of his name or the reference to him, and he should consider what other actions might be appropriate.[7]

.08 Condensed financial statements derived from audited financial statements of a public entity may be presented on a comparative basis with interim financial information as of a subsequent date that is accompanied by the auditor's review report. In that case, the auditor should report on the condensed

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[6] If such a statement is made in a client-prepared document that does not include audited financial statements and the client is not a public entity that is required to file complete audited financial statements with a regulatory agency (at least annually), the auditor would ordinarily express an adverse opinion on the condensed financial statements because of inadequate disclosure. (See section 508, *Reports on Audited Financial Statements*, paragraphs .41 through .44.) The auditor would not be expected to provide the disclosure in his report. The following is an example of an auditor's report on condensed financial statements in such circumstances when the auditor had previously audited and reported on the complete financial statements:

Independent Auditor's Report

We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related earnings, and cash flows for the year then ended (not presented herein). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion. The condensed consolidated balance sheet as of December 31, 20X0, and the related condensed statements of income, retained earnings, and cash flows for the year then ended, presented on pages xx-xx, are presented as a summary and therefore do not include all of the disclosures required by accounting principles generally accepted in the United States of America. In our opinion, because of the significance of the omission of the information referred to in the preceding paragraph, the condensed consolidated financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company and subsidiaries as of December 31, 20X0, or the results of its operations or its cash flows for the year then ended.

[Footnote revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

[7] In considering what other actions, if any, may be appropriate in these circumstances, the auditor may wish to consult his legal counsel.

financial statements of each period in a manner appropriate for the type of service provided for each period. The following is an example of a review report on a condensed balance sheet as of March 31, 19X1, and the related condensed statements of income and cash flows for the three-month periods ended March 31, 19X1 and 19X0, together with a report on a condensed balance sheet derived from audited financial statements as of December 31, 19X0, included in Form 10-Q:[8]

> We have reviewed the condensed consolidated balance sheet of ABC Company and subsidiaries as of March 31, 19X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 19X1 and 19X0. These financial statements are the responsibility of the company's management.
>
> We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.
>
> Based on our review, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with generally accepted accounting principles.
>
> We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 20X0, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

[Revised, May 1992, to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards No. 71. Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

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[8] Regulation S-X specifies that the following financial information should be provided in filings on Form 10-Q:

a. An interim balance sheet as of the end of the most recent fiscal quarter and a balance sheet (which may be condensed to the same extent as the interim balance sheet) as of the end of the preceding fiscal year.

b. Interim condensed statements of income for the most recent fiscal quarter, for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding periods of the preceding fiscal year.

c. Interim condensed cash flow statements for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter and for the corresponding period for the preceding fiscal year. The Securities and Exchange Commission requires a registrant to engage an independent accountant to review the registrant's interim financial information before the registrant files its interim financial information on Form 10-Q or Form 10-QSB. If the auditor has made a review of interim financial information, he may agree to the reference to his name and the inclusion of his review report in a Form 10-Q. (See section 722, *Interim Financial Information*, paragraph .03.) [Footnote revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 100.]

Selected Financial Data

.09 An auditor may be engaged to report on selected financial data that are included in a client-prepared document that contains audited financial statements (or, with respect to a public entity, that incorporates such statements by reference to information filed with a regulatory agency). Selected financial data are not a required part of the basic financial statements, and the entity's management is responsible for determining the specific selected financial data to be presented.[9] If the auditor is engaged to report on the selected financial data, his report should be limited to data that are derived from audited financial statements (which may include data that are calculated from amounts presented in the financial statements, such as working capital). If the selected financial data that management presents include both data derived from audited financial statements and other information (such as number of employees or square footage of facilities), the auditor's report should specifically identify the data on which he is reporting. The report should indicate (*a*) that the auditor has audited and expressed an opinion on the complete financial statements, (*b*) the type of opinion expressed,[10] and (*c*) whether, in the auditor's opinion, the information set forth in the selected financial data is fairly stated in all material respects in relation to the complete financial statements from which it has been derived.[11] If the selected financial data for any of the years presented are derived from financial statements that were audited by another independent auditor, the report on the selected financial data should state that fact, and the auditor should not express an opinion on that data.

.10 The following is an example of an auditor's report that includes an additional paragraph because he is also engaged to report on selected financial data for a five-year period ended December 31, 19X5, in a client-prepared document that includes audited financial statements:

Independent Auditor's Report

We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 19X5 and 19X4, and the related consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X5. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as

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[9] Under regulations of the SEC, certain reports must include, for each of the last five fiscal years, selected financial data in accordance with regulation S-K, including net sales or operating revenues, income or loss from continuing operations, income or loss from continuing operations per common share, total assets, long-term obligations and redeemable preferred stock and cash dividends declared per common share. Registrants may include additional items that they believe may be useful. There is no SEC requirement for the auditor to report on selected financial data.

[10] See footnote 5.

[11] Nothing in this section is intended to preclude an auditor from expressing an opinion on one or more specified elements, accounts, or items of a financial statement, providing the provisions of section 623, *Special Reports*, are observed.

evaluating the overall financial statement presentation. We believe that our audits provided a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the ABC Company and subsidiaries as of December 31, 20X5 and 20X4, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 20X5, in conformity with accounting principles generally accepted in the United States of America.

We have also previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheets as of December 31, 20X3, 20X2, and 20X1, and the related statements of income, retained earnings, and cash flows for the years ended December 31, 20X2, and 20X1 (none of which are presented herein); and we expressed unqualified opinions on those consolidated financial statements. In our opinion, the information set forth in the selected financial data for each of the five years in the period ended December 31, 20X5, appearing on page xx, is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

.11 In introductory material regarding the selected financial data included in a client-prepared document, an entity might name the independent auditor and state that the data are derived from financial statements that he audited. Such a statement does not, in itself, require the auditor to report on the selected financial data, provided that the selected financial data are presented in a document that contains audited financial statements (or, with respect to a public entity, that incorporates such statements by reference to information filed with a regulatory agency). If such a statement is made in a document that does not include (or incorporate by reference) audited financial statements, the auditor should request that neither his name nor reference to him be associated with the information, or he should disclaim an opinion on the selected financial data and request that the disclaimer be included in the document. If the client does not comply, the auditor should advise the client that he does not consent to either the use of his name or the reference to him, and he should consider what other actions might be appropriate.[12]

Effective Date

.12 This section is effective for reports issued or reissued on or after January 1, 1989. Earlier application of the provision of this section is permissible.

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[12] See footnote 7.

AU Section 558

Required Supplementary Information

(Supersedes section 553)[*]

Source: SAS No. 52; SAS No. 98.

See section 9558 for interpretations of this section.

Issue date, unless otherwise indicated: April, 1988.

.01 The Financial Accounting Standards Board (FASB), Governmental Accounting Standards Board (GASB), and the Federal Accounting Standards Advisory Board (FASAB) develop standards for financial reporting, including standards for financial statements and for certain other information supplementary to financial statements.[1] This section provides the independent auditor with

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[*] This section also withdraws the following Statements on Auditing Standards:

- Statement on Auditing Standards No. 28, *Supplementary Information on the Effects of Changing Prices* [Formerly section 554].
- Statement on Auditing Standards No. 40, *Supplementary Mineral Reserve Information* [Formerly section 556].
- Statement on Auditing Standards No. 45, *Supplementary Oil and Gas Reserve Information* [Formerly section 557]. SAS No. 45 was reissued as an auditing interpretation, see section 9558.01-.06.

[1] The FASB, GASB, and FASAB's roles in setting standards for financial reporting have been recognized by the AICPA Council. The FASB's authority to establish standards for disclosure of financial information outside of the basic financial statements is described in the following resolution:

> That as of (September 19, 1987), the FASB, in respect of statements of financial accounting standards finally adopted by such board in accordance with its rules of procedure and the bylaws of the Financial Accounting Foundation, be, and hereby is, designated by this Council as the body to establish accounting principles pursuant to rule 203 and standards on disclosure of financial information for such entities outside financial statements in published financial reports containing financial statements under rule 202 of the *Rules of the Code of Professional Conduct* of the American Institute of Certified Public Accountants provided, however, any accounting research bulletins, or opinions of the accounting principles board issued or approved for exposure by the accounting principles board prior to April 1, 1973, and finally adopted by such board on or before June 30, 1973, shall constitute statements of accounting principles promulgated by a body designated by Council as contemplated in rule 203 of the *Rules of the Code of Professional Conduct* unless and until such time as they are expressly superseded by action of the FASB.

The GASB's authority to establish standards for financial reporting is described in the following resolution:

> That as of (September 19, 1987), the GASB, with respect to statements of governmental accounting standards adopted and issued in July 1984 and subsequently in accordance with its rules of procedure and the bylaws of the FASB, be, and hereby is, designated by the Council of the American Institute of Certified Public Accountants as the body to establish financial accounting principles for state and local governmental entities pursuant to rule 203, and standards on disclosure of financial information for such entities outside financial statements in published financial reports containing financial statements under rule 202. The FASAB's authority to establish standards for financial reporting for federal government entities is described in the following resolution:
>
> That as of (October 19, 1999), the FASAB is designated under rule 203 of the AICPA's *Code of Professional Conduct* as the body to establish accounting principles for federal government entities, and be it further resolved to recognize the Federal Accounting Standards Advisory Board with respect to statements of federal accounting standards adopted and issued in March of 1993 and subsequently in accordance with the FASAB's rules of procedure, and be it further resolved that no later than five years from the date the FASAB is granted rule 203 authority, the AICPA's Board of Directors will review the mission and operations of the FASAB and will evaluate whether the FASAB continues to meet council-approved criteria used to assess standards setting bodies designated under rule 203. Upon such review and evaluation, the AICPA's board shall recommend to council whether council shall continue to designate the FASAB under rule 203. [Footnote revised, April 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 91.]

guidance on the nature of procedures to be applied to supplementary information required by the FASB, GASB, or FASAB and describes the circumstances that would require the auditor to report such information. [Revised, April 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 91.]

Applicability

.02 This section is applicable in an audit in accordance with generally accepted auditing standards of financial statements included in a document that should contain supplementary information required by generally accepted accounting principles (GAAP). However, this section is not applicable if the auditor has been engaged to audit such supplementary information.[2] [Revised, April 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 91. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.03 Some entities may voluntarily include, in documents containing audited financial statements, certain supplementary information that is required of other entities. When an entity voluntarily includes such information as a supplement to the financial statements or in an unaudited note to the financial statements, the provisions of this section are applicable unless either the entity indicates that the auditor has not applied the procedures described in this section or the auditor includes in an explanatory paragraph in his report on the audited financial statements a disclaimer on the information.[3] The following is an example of a disclaimer an auditor might use in these circumstances:

> The [*identify the supplementary information*] on page XX (or in Note XX) is not a required part of the basic financial statements, and we did not audit or apply limited procedures to such information and do not express any assurances on such information.

When the auditor does not apply the procedures described in this section to a voluntary presentation of required supplementary information required for other entities, the provisions of section 550, apply.

Involvement With Information Outside Financial Statements

.04 The objective of an audit of financial statements in accordance with generally accepted auditing standards is the expression of an opinion on such statements. The auditor has no responsibility to audit information outside the basic financial statements in accordance with generally accepted auditing standards. However, the auditor does have certain responsibilities with respect to information outside the financial statements. The nature of the

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[2] This section is not applicable to entities that voluntarily present supplementary information not required by GAAP. For example, entities that voluntarily present supplementary information on the effects of inflation and changes in specific prices, formerly required by FASB Statement No. 33, *Financial Reporting and Changing Prices*, are guided by section 550, *Other Information in Documents Containing Audited Financial Statements*. [Footnote revised, April 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 91. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

[3] When supplementary information is presented in an auditor-submitted document outside the basic financial statements, the guidance in section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, as amended by SAS No. 52, *Omnibus Statement on Auditing Standards—1987*, should be followed.

auditor's responsibility varies with the nature of both the information and the document containing the financial statements.

.05 The auditor's responsibility for other information not required by the FASB, GASB, or FASAB but included in certain annual reports—which are client-prepared documents[4]—is specified in section 550. The auditor's responsibility for information outside the basic financial statements in documents that the auditor submits to the client or to others is specified in section 551. The auditor's responsibility for supplementary information required by the FASB, GASB or FASAB (called *required supplementary information*) is discussed in the paragraphs that follow. [Revised, April 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 91.]

Involvement With Required Supplementary Information

.06 Required supplementary information differs from other types of information outside the basic financial statements because the FASB, GASB or FASAB considers the information an essential part of the financial reporting of certain entities and because authoritative guidelines for the measurement and presentation of the information have been established. Accordingly, the auditor should apply certain limited procedures to required supplementary information and should report deficiencies in, or the omission of, such information. [Revised, April 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 91.]

Procedures

.07 The auditor should consider whether supplementary information is required by the FASB or GASB in the circumstances. If supplementary information is required, the auditor ordinarily should apply the following procedures to the information.[5]

a. Inquire of management about the methods of preparing the information, including (1) whether it is measured and presented within prescribed guidelines, (2) whether methods of measurement or presentation have been changed from those used in the prior period and the reasons for any such changes, and (3) any significant assumptions or interpretations underlying the measurement or presentation.

b. Compare the information for consistency with (1) management's responses to the foregoing inquiries, (2) audited financial statements,[6] and (3) other knowledge obtained during the examination of the financial statements.

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[4] Client-prepared documents include financial reports prepared by the client but merely reproduced by the auditor on the client's behalf.

[5] These procedures are also appropriate when the auditor is involved with voluntary presentations of such information required for other entities (see paragraph .03).

[6] GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, requires presentation of certain 6-year historical trend information relating to pension activities as supplementary information outside the basic financial statements. Such information is generally derived from financial statements. If such required supplementary information has been derived from audited financial statements and is presented outside the basic financial statements in an auditor-submitted document, the auditor may report on this information as indicated in section 552, *Reporting on Condensed Financial Statements and Selected Financial Data*, paragraph .10. [Footnote revised, April 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 91.]

c. Consider whether representations on required supplementary information should be included in specific written representations obtained from management (section 333, *Management Representations*).

d. Apply additional procedures, if any, that other statements, interpretations, guides, or statements of position prescribe for specific types of required supplementary information.

e. Make additional inquiries if application of the foregoing procedures causes the auditor to believe that the information may not be measured or presented within applicable guidelines.

Reporting on Required Supplementary Information

.08 Since the supplementary information is not audited and is not a required part of the basic financial statements, the auditor need not add an explanatory paragraph to the report on the audited financial statements to refer to the supplementary information or to his or her limited procedures, except in any of the following circumstances:[7] (*a*) the supplementary information that GAAP requires to be presented in the circumstances is omitted; (*b*) the auditor has concluded that the measurement or presentation of the supplementary information departs materially from prescribed guidelines; (*c*) the auditor is unable to complete the prescribed procedures; (*d*) the auditor is unable to remove substantial doubts about whether the supplementary information conforms to prescribed guidelines. Since the required supplementary information does not change the standards of financial accounting and reporting used for the preparation of the entity's basic financial statements, the circumstances described above do not affect the auditor's opinion on the fairness of presentation of such financial statements in conformity with generally accepted accounting principles. Furthermore, the auditor need not present the supplementary information if it is omitted by the entity. The following are examples of additional explanatory paragraphs an auditor might use in these circumstances.

Omission of Required Supplementary Information

The (Company or Governmental Unit) has not presented [*describe the supplementary information required by GAAP*[†]] that accounting principles generally accepted in the United States has determined is necessary to supplement, although not required to be part of, the basic financial statements.

Material Departures From Guidelines

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary

[7] When required supplementary information is presented outside the basic financial statements in an auditor-submitted document, the auditor should (*a*) express an opinion on the information if engaged to examine the information; (*b*) report on such information using the guidance in section 551.12 and .14, provided such information has been subjected to the auditing procedures applied in the audit of the basic financial statements; or (*c*) disclaim an opinion on the information (see section 551.15 and .16). [As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

[†] The auditor may identify the body requiring the information, such as the Financial Accounting Standards Board or the Governmental Accounting Standards Board. [Footnote added, effective September 2002, by Statement on Auditing Standards No. 98.]

information. As a result of such limited procedures, we believe that the [*specifically identify the supplementary information*] is not in conformity with accounting principles generally accepted in the United States because [*describe the material departure(s) from the GAAP*†].

Prescribed Procedures Not Completed

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because [*state the reasons*].

Unresolved Doubts About Adherence to Guidelines

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by accounting principles generally accepted in the United States. [*The auditor should consider including in the report the reason(s) he or she was unable to resolve his or her substantial doubts.*]

Even though the auditor is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in the report. [Revised, April 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 91. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.09 In conjunction with the audit of the financial statements, the auditor may subject the supplementary information to certain auditing procedures. If the procedures are sufficient to enable the auditor to express an opinion on whether the information is fairly stated in all material respects in relation to the financial statements taken as a whole, the auditor may expand the audit report in accordance with section 550.07. [Paragraph added, effective September 2002, by Statement on Auditing Standards No. 98.]

.10 If the entity includes with the supplementary information an indication that the auditor performed any procedures regarding the information without also indicating that the auditor does not express an opinion on the information presented, the auditor's report on the audited financial statements should be expanded to include a disclaimer on the information or, if appropriate, an opinion on whether the information is fairly stated in all material respects in relation to the financial statements taken as a whole. [Paragraph renumbered and amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.11 Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by GAAP. However, management may choose not to place the required supplementary information

† The auditor may identify the body requiring the information, such as the Financial Accounting Standards Board or the Governmental Accounting Standards Board. [Footnote added, effective September 2002, by Statement on Auditing Standards No. 98.]

outside the basic financial statements. In such circumstances, unless it is audited as part of the basic financial statements, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report on the audited financial statements should be expanded to include a disclaimer on the supplementary information. [Revised, April 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 91. Paragraph renumbered and amended, effective September 2002, by Statement on Auditing Standards No. 98.]

AU Section 9558

Required Supplementary Information: Auditing Interpretations of Section 558

1. Supplementary Oil and Gas Reserve Information

.01 *Question*—FASB Statement No. 69, *Disclosures About Oil and Gas Producing Activities* [AC section Oi5], which amended FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies* [AC section Oi5], and FASB Statement No. 25, *Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies* [AC section Oi5], requires publicly traded entities that have significant oil and gas producing activities to include, with complete sets of annual financial statements, disclosures of proved oil and gas reserve quantities, changes in reserve quantities, a standardized measure of discounted future net cash flows relating to reserve quantities, and changes in the standardized measure. In documents filed with the Securities and Exchange Commission (SEC), Regulation S-K requires that the disclosures related to annual periods be presented for each annual period for which an income statement is required and the disclosures as of the end of an annual period be presented as of the date of each audited balance sheet required. These disclosures are considered to be supplementary information and may be presented outside the basic financial statements. In these circumstances, should the auditor consider the provisions of section 558, *Required Supplementary Information*?

.02 *Interpretation*—Yes. Also, in addition to the provisions of section 558, the auditor should also consider the provisions of this Interpretation.

.03 Estimating oil and gas reserves is a complex process requiring the knowledge and experience of a reservoir engineer. In general, the quality of the estimate of proved reserves for an individual reservoir depends on the availability, completeness, and accuracy of data needed to develop the estimate and on the experience and judgment of the reservoir engineer. Estimates of proved reserves inevitably change over time as additional data become available and are taken into account. The magnitude of changes in these estimates is often substantial. Because oil and gas reserve estimates are more imprecise than most estimates that are made in preparing financial statements, entities are encouraged to explain the imprecise nature of such reserve estimates.

.04 In applying the procedures specified in section 558, the auditor's inquiries should be directed to management's understanding of the specific requirements for disclosure of the supplementary oil and gas reserve information, including—

a. The factors considered in determining the reserve quantity information to be reported, such as including in the information (1) quantities of all domestic and foreign proved oil and gas reserves owned by the entity net of interests of others, (2) reserves attributable to consolidated subsidiaries, (3) a proportionate share of reserves of investees that are proportionately consolidated, and (4) reserves relating to royalty interests owned.

b. The separate disclosure of items such as (1) the entity's share of oil and gas produced from royalty interests for which reserve quantity information is unavailable, (2) reserves subject to long-term agreements with governments or authorities in which the entity participates in the operation or otherwise serves as producer, (3) the entity's proportional interest in reserves of investees accounted for by the equity method, (4) subsequent events, important economic factors, or significant uncertainties affecting particular components of the reserve quantity information, (5) whether the entity's reserves are located entirely within its home country, and (6) whether certain named governments restrict the disclosure of reserves or require that the reserve estimates include reserves other than proved.

c. The factors considered in determining the standardized measure of discounted future net cash flows to be reported.

.05 In addition, the auditor should also—

a. Inquire about whether the person who estimated the entity's reserve quantity information has appropriate qualifications.[1]

b. Compare the entity's recent production with its reserve estimates for properties that have significant production or significant reserve quantities and inquire about disproportionate ratios.

c. Compare the entity's reserve quantity information with the corresponding information used for depletion and amortization, and make inquiries when differences exist.

d. Inquire about the calculation of the standardized measure of discounted future net cash flows. These inquiries might include matters such as whether—

i. The prices used to develop future cast inflows from estimated production of the proved reserves are based on prices received at the end of the entity's fiscal year, and whether the calculation of future cash inflows appropriately reflects the terms of sales contracts and applicable governmental laws and regulations.

ii. The entity's estimate of the nature and timing of future development of the proved reserves and the future rates of production are consistent with available development plans.

iii. The entity's estimates of future development and production costs are based on year-end costs and assumed continuation of existing economic conditions.

iv. Future income tax expenses have been computed using the appropriate year-end statutory tax rates, with consideration of future tax rates already legislated, after giving

[1] For example, the Society of Petroleum Engineers has prepared "Standards Pertaining to the Estimating and Auditing of Oil and Gas Reserve Information," which indicate that a reserve estimator would normally be considered to be qualified if he or she (1) has a minimum of three years' practical experience in petroleum engineering or petroleum production geology, with at least one year of such experience being in the estimation and evaluation of reserve information; and (2) either (*a*) has obtained, from a college or university of recognized stature, a bachelor's or advanced degree in petroleum engineering, geology, or other discipline of engineering or physical science or (*b*) has received, and is maintaining in good standing, a registered or certified professional engineer's license or a registered or certified professional geologist's license, or the equivalent thereof, from an appropriate governmental authority or professional organization.

effect to the tax basis of the properties involved, permanent differences, and tax credits and allowances.

v. The future net cash flows have been appropriately discounted.

vi. With respect to full cost companies, the estimated future development costs are consistent with the corresponding amounts used for depletion and amortization purposes.

vii. With respect to the disclosure of changes in the standardized measure of discounted future net cash flows, the entity has computed and presented the sources of the changes in conformity with the requirements of FASB Statement No. 69 [AC section Oi5].

e. Inquire about whether the methods and bases for estimating the entity's reserve information are documented and whether the information is current.

.06 If the auditor believes that the information may not be presented within the applicable guidelines, section 558 indicates that he ordinarily should make additional inquires. However, because of the nature of estimates of oil and gas reserve information, the auditor may not be in a position to evaluate the responses to such additional inquiries and, thus, will need to report this limitation on the procedures prescribed by professional standards. The following is an example that illustrates reporting on oil and gas reserve information in that event.

> The oil and gas reserve information is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by the Financial Accounting Standards Board. [The auditor should consider including in his report the reason(s) why he was unable to resolve his doubts. For example, the auditor may wish to state that the information was estimated by a person lacking appropriate qualifications.]

[Issue Date: February, 1989.]

AU Section 560

Subsequent Events

Source: SAS No. 1, section 560; SAS No. 12; SAS No. 98; Auditing Standard No. 5.

Issue date, unless otherwise indicated: November, 1972.

.01 An independent auditor's report ordinarily is issued in connection with historical financial statements that purport to present financial position at a stated date and results of operations and cash flows for a period ended on that date. However, events or transactions sometimes occur subsequent to the balance-sheet date, but prior to the issuance of the financial statements, that have a material effect on the financial statements and therefore require adjustment or disclosure in the statements. These occurrences hereinafter are referred to as "subsequent events." [As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]

> Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 93–97 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, which provide direction with respect to subsequent events in an audit of internal control over financial reporting.

.02 Two types of subsequent events require consideration by management and evaluation by the independent auditor.

.03 The first type consists of those events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements. All information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based. The financial statements should be adjusted for any changes in estimates resulting from the use of such evidence.

.04 Identifying events that require adjustment of the financial statements under the criteria stated above calls for the exercise of judgment and knowledge of the facts and circumstances. For example, a loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy subsequent to the balance-sheet date would be indicative of conditions existing at the balance-sheet date, thereby calling for adjustment of the financial statements before their issuance. On the other hand, a similar loss resulting from a customer's major casualty such as a fire or flood subsequent to the balance-sheet date would not be indicative of conditions existing at the balance-sheet date and adjustment of the financial statements would not be appropriate. The settlement of litigation for an amount different from the liability recorded in the accounts would require adjustment of the financial statements if the events, such as personal injury or patent infringement, that gave rise to the litigation had taken place prior to the balance-sheet date.

.05 The second type consists of those events that provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. These events should not result in adjustment of the financial statements.[1] Some of these events, however, may be of such a nature that disclosure of them is required to keep the financial statements from being misleading. Occasionally such an event may be so significant that disclosure can best be made by supplementing the historical financial statements with pro forma financial data giving effect to the event as if it had occurred on the date of the balance sheet. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical statements.

.06 Examples of events of the second type that require disclosure to the financial statements (but should not result in adjustment) are:

a. Sale of a bond or capital stock issue.

b. Purchase of a business.

c. Settlement of litigation when the event giving rise to the claim took place subsequent to the balance-sheet date.

d. Loss of plant or inventories as a result of fire or flood.

e. Losses on receivables resulting from conditions (such as a customer's major casualty) arising subsequent to the balance-sheet date.

.07 Subsequent events affecting the realization of assets such as receivables and inventories or the settlement of estimated liabilities ordinarily will require adjustment of the financial statements (see paragraph .03) because such events typically represent the culmination of conditions that existed over a relatively long period of time. Subsequent events such as changes in the quoted market prices of securities ordinarily should not result in adjustment of the financial statements (see paragraph .05) because such changes typically reflect a concurrent evaluation of new conditions.

.08 When financial statements are reissued, for example, in reports filed with the Securities and Exchange Commission or other regulatory agencies, events that require disclosure in the reissued financial statements to keep them from being misleading may have occurred subsequent to the original issuance of the financial statements. Events occurring between the time of original issuance and reissuance of financial statements should not result in adjustment of the financial statements[2] unless the adjustment meets the criteria for the correction of an error or the criteria for prior period adjustments set forth in Opinions of the Accounting Principles Board.[*] Similarly, financial statements reissued in comparative form with financial statements of subsequent periods should not be adjusted for events occurring subsequent to the original issuance unless the adjustment meets the criteria stated above.

.09 Occasionally, a subsequent event of the second type has such a material impact on the entity that the auditor may wish to include in his report an explanatory paragraph directing the reader's attention to the event and its effects. (See section 508.19.)

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[1] This paragraph is not intended to preclude giving effect in the balance sheet, with appropriate disclosure, to stock dividends or stock splits or reverse splits consummated after the balance-sheet date but before issuance of the financial statements.

[2] However, see paragraph .05 as to the desirability of presenting pro forma financial statements to supplement the historical financial statements in certain circumstances.

[*] See also Statement of Financial Accounting Standards No. 16, *Prior Period Adjustments* (AC section A35).

Auditing Procedures in the Subsequent Period

.10 There is a period after the balance-sheet date with which the auditor must be concerned in completing various phases of his audit. This period is known as the "subsequent period" and is considered to extend to the date of the auditor's report. Its duration will depend upon the practical requirements of each audit and may vary from a relatively short period to one of several months. Also, all auditing procedures are not carried out at the same time and some phases of an audit will be performed during the subsequent period, whereas other phases will be substantially completed on or before the balance-sheet date. As an audit approaches completion, the auditor will be concentrating on the unresolved auditing and reporting matters and he is not expected to be conducting a continuing review of those matters to which he has previously applied auditing procedures and reached satisfaction.

.11 Certain specific procedures are applied to transactions occurring after the balance-sheet date such as (*a*) the examination of data to assure that proper cutoffs have been made and (*b*) the examination of data which provide information to aid the auditor in his evaluation of the assets and liabilities as of the balance-sheet date.

.12 *[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]*

In addition, the independent auditor should perform other auditing procedures with respect to the period after the balance-sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to a fair presentation of the financial statements in conformity with generally accepted accounting principles. These procedures should be performed at or near the date of the auditor's report. The auditor generally should:

a. Read the latest available interim financial statements; compare them with the financial statements being reported upon; and make any other comparisons considered appropriate in the circumstances. In order to make these procedures as meaningful as possible for the purpose expressed above, the auditor should inquire of officers and other executives having responsibility for financial and accounting matters as to whether the interim statements have been prepared on the same basis as that used for the statements under audit.

b. Inquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to:

(i) Whether any substantial contingent liabilities or commitments existed at the date of the balance sheet being reported on or at the date of inquiry.

(ii) Whether there was any significant change in the capital stock, long-term debt, or working capital to the date of inquiry.

(iii) The current status of items, in the financial statements being reported on, that were accounted for on the basis of tentative, preliminary, or inconclusive data.

(iv) Whether any unusual adjustments had been made during the period from the balance-sheet date to the date of inquiry.

c. Read the available minutes of meetings of stockholders, directors, and appropriate committees; as to meetings for which minutes are not available, inquire about matters dealt with at such meetings.

d. Inquire of client's legal counsel concerning litigation, claims, and assessments. [As amended, January 1976, by Statement on Auditing Standards No. 12.] (See section 337.)

e. Obtain a letter of representations, dated as of the date of the auditor's report, from appropriate officials, generally the chief executive officer, chief financial officer, or others with equivalent positions in the entity, as to whether any events occurred subsequent to the date of the financial statements being reported on by the independent auditor that in the officer's opinion would require adjustment or disclosure in these statements. The auditor may elect to have the client include representations as to significant matters disclosed to the auditor in his performance of the procedures in subparagraphs (*a*) to (*d*) above and (*f*) below. (See section 333, *Management Representations*.)

f. Make such additional inquiries or perform such procedures as he considers necessary and appropriate to dispose of questions that arise in carrying out the foregoing procedures, inquiries, and discussions.

AU Section 561

Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

Source: SAS No. 1, section 561; SAS No. 98; Auditing Standard No. 5; Auditing Standard No. 6.

See section 9561 for interpretations of this section.

Issue date, unless otherwise indicated: November, 1972.

.01 The procedures described in this section should be followed by the auditor who, subsequent to the date of the report upon audited financial statements, becomes aware that facts may have existed at that date which might have affected the report had he or she then been aware of such facts.[1] [As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]

> Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 98 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, which provides direction with respect to the subsequent discovery of information existing at the date of the auditor's report on internal control over financial reporting.

.02 Because of the variety of conditions which might be encountered, some of these procedures are necessarily set out only in general terms; the specific actions to be taken in a particular case may vary somewhat in the light of the circumstances. The auditor would be well advised to consult with an attorney when he or she encounters the circumstances to which this section may apply because of legal implications that may be involved in actions contemplated herein, including, for example, the possible effect of state statutes regarding confidentiality of auditor-client communications. [As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.03 After the date of the report, the auditor has no obligation[2] to make any further or continuing inquiry or perform any other auditing procedures with respect to the audited financial statements covered by that report, unless new information which may affect the report comes to his or her attention. [As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

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[1] If the financial statements have not yet been issued, see the guidance found in section 560, *Subsequent Events*. [Footnote added, effective September 2002, by Statement on Auditing Standards No. 98.]

[2] However, see section 711.10–.13 as to an auditor's obligation with respect to audited financial statements included in registration statements filed under the Securities Act of 1933 between the date of the auditor's report and the effective date of the registration statement. [Footnote revised by the issuance of Statement on Auditing Standards No. 37, April 1981. Footnote renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

.04 When the auditor becomes aware of information which relates to financial statements previously reported on by him, but which was not known to him at the date of his report, and which is of such a nature and from such a source that he would have investigated it had it come to his attention during the course of his audit, he should, as soon as practicable, undertake to determine whether the information is reliable and whether the facts existed at the date of his report. In this connection, the auditor should discuss the matter with his client at whatever management levels he deems appropriate, including the board of directors, and request cooperation in whatever investigation may be necessary.

.05 When the subsequently discovered information is found both to be reliable and to have existed at the date of the auditor's report, the auditor should take action in accordance with the procedures set out in subsequent paragraphs if the nature and effect of the matter are such that (*a*) his report would have been affected if the information had been known to him at the date of his report and had not been reflected in the financial statements and (*b*) he believes there are persons currently relying or likely to rely on the financial statements who would attach importance to the information. With respect to (*b*), consideration should be given, among other things, to the time elapsed since the financial statements were issued.

.06 When the auditor has concluded, after considering (*a*) and (*b*) in paragraph .05, that action should be taken to prevent future reliance on his report, he should advise his client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently relying or who are likely to rely on the financial statements and the related auditor's report. When the client undertakes to make appropriate disclosure, the method used and the disclosure made will depend on the circumstances.

a. If the effect on the financial statements or auditor's report of the subsequently discovered information can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and auditor's report. The reasons for the revision usually should be described in a note to the financial statements and referred to in the auditor's report. Generally, only the most recently issued audited financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.[3]

b. When issuance of financial statements accompanied by the auditor's report for a subsequent period is imminent, so that disclosure is not delayed, appropriate disclosure of the revision can be made in such statements instead of reissuing the earlier statements pursuant to subparagraph (*a*).[4]

c. When the effect on the financial statements of the subsequently discovered information cannot be determined without a prolonged investigation, the issuance of revised financial statements and auditor's report would necessarily be delayed. In this circumstance, when it appears that the information will require a revision of the statements, appropriate disclosure would consist of notification

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[3] *[The following footnote is effective November 15, 2008. See PCAOB Release 2008-001.]* See paragraphs 26 and 27 of Accounting Principles Board Opinion No. 9 and paragraphs 25 and 26 of FASB Statement No. 154, regarding disclosure of adjustments applicable to prior periods.

[4] Ibid. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

by the client to persons who are known to be relying or who are likely to rely on the financial statements and the related report that they should not be relied upon, and that revised financial statements and auditor's report will be issued upon completion of an investigation. If applicable, the client should be advised to discuss with the Securities and Exchange Commission, stock exchanges, and appropriate regulatory agencies the disclosure to be made or other measures to be taken in the circumstances.

.07 The auditor should take whatever steps he deems necessary to satisfy himself that the client has made the disclosures specified in paragraph .06.

.08 If the client refuses to make the disclosures specified in paragraph .06, the auditor should notify each member of the board of directors of such refusal and of the fact that, in the absence of disclosure by the client, the auditor will take steps as outlined below to prevent future reliance upon his report. The steps that can appropriately be taken will depend upon the degree of certainty of the auditor's knowledge that there are persons who are currently relying or who will rely on the financial statements and the auditor's report, and who would attach importance to the information, and the auditor's ability as a practical matter to communicate with them. Unless the auditor's attorney recommends a different course of action, the auditor should take the following steps to the extent applicable:

a. Notification to the client that the auditor's report must no longer be associated with the financial statements.

b. Notification to regulatory agencies having jurisdiction over the client that the auditor's report should no longer be relied upon.

c. Notification to each person known to the auditor to be relying on the financial statements that his report should no longer be relied upon. In many instances, it will not be practicable for the auditor to give appropriate individual notification to stockholders or investors at large, whose identities ordinarily are unknown to him; notification to a regulatory agency having jurisdiction over the client will usually be the only practicable way for the auditor to provide appropriate disclosure. Such notification should be accompanied by a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure. The Securities and Exchange Commission and the stock exchanges are appropriate agencies for this purpose as to corporations within their jurisdictions.

.09 The following guidelines should govern the content of any disclosure made by the auditor in accordance with paragraph .08 to persons other than his client:

a. If the auditor has been able to make a satisfactory investigation of the information and has determined that the information is reliable:

(i) The disclosure should describe the effect the subsequently acquired information would have had on the auditor's report if it had been known to him at the date of his report and had not been reflected in the financial statements. The disclosure should include a description of the nature of the subsequently acquired information and of its effect on the financial statements.

(ii) The information disclosed should be as precise and factual as possible and should not go beyond that which is reasonably necessary to accomplish the purpose mentioned in the preceding subparagraph (*i*). Comments concerning the conduct or motives of any person should be avoided.

b. If the client has not cooperated and as a result the auditor is unable to conduct a satisfactory investigation of the information, his disclosure need not detail the specific information but can merely indicate that information has come to his attention which his client has not cooperated in attempting to substantiate and that, if the information is true, the auditor believes that his report must no longer be relied upon or be associated with the financial statements. No such disclosure should be made unless the auditor believes that the financial statements are likely to be misleading and that his report should not be relied on.

.10 The concepts embodied in this section are not limited solely to corporations but apply in all cases where financial statements have been audited and reported on by independent auditors.

AU Section 9561

Subsequent Discovery of Facts Existing at the Date of the Auditor's Report: Auditing Interpretations of Section 561

1. Auditor Association With Subsequently Discovered Information When the Auditor Has Resigned or Been Discharged

.01 *Question*—New information may come to an auditor's attention subsequent to the date of his report on audited financial statements that might affect the previously issued audit report. Is the auditor's responsibility with respect to that information different if the auditor has resigned or been discharged prior to undertaking or completing his investigation than if he were the continuing auditor?

.02 *Interpretation*—No. Section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, requires the auditor to undertake to determine whether the information is reliable and whether the facts existed at the date of his report. This undertaking must be performed even when the auditor has resigned or been discharged.

[Issue Date: February, 1989.]

AU Section 600
OTHER TYPES OF REPORTS

TABLE OF CONTENTS

AU Section 622

Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement

(Supersedes SAS No. 35)

Source: SAS No. 75; SAS No. 87; SAS No. 93.

Notice of Withdrawal of Statement on Auditing Standards (SAS) No. 75, Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement and Auditing Interpretation No. 1, "Applying Agreed-Upon Procedures to All, or Substantially All, of the Elements, Accounts, or Items of a Financial Statement"

The Auditing Standards Board (ASB) has withdrawn SAS No. 75, Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement, and its Interpretation in order to consolidate the guidance applicable to agreed-upon procedures engagements in professional standards. For guidance relating to performing and reporting on agreed-upon procedures engagements, practitioners should refer to AT section 201, Agreed-Upon Procedures Engagements.

AU Section 9622

Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement: Auditing Interpretations of Section 622

[1.] Applying Agreed-Upon Procedures to All, or Substantially All, of the Elements, Accounts, or Items of a Financial Statement

[.01–.02]

Notice of Withdrawal of Statement on Auditing Standards (SAS) No. 75, Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement and Auditing Interpretation No. 1, "Applying Agreed-Upon Procedures to All, or Substantially All, of the Elements, Accounts, or Items of a Financial Statement"

The Auditing Standards Board (ASB) has withdrawn SAS No. 75, Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement, and its Interpretation in order to consolidate the guidance applicable to agreed-upon procedures engagements in professional standards. For guidance relating to performing and reporting on agreed-upon procedures engagements, practitioners should refer to AT section 201, Agreed-Upon Procedures Engagements.

AU Section 623

Special Reports

(Supersedes section 621)

Source: SAS No. 62; SAS No. 77.

See section 9623 for interpretations of this section.

Effective for reports issued on or after July 1, 1989, unless otherwise indicated.

Introduction

.01 This section applies to auditors' reports issued in connection with the following:

a. Financial statements that are prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles (paragraphs .02 through .10)

b. Specified elements, accounts, or items of a financial statement (paragraphs .11 through .18)

c. Compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements (paragraphs .19 through .21)

d. Financial presentations to comply with contractual agreements or regulatory provisions (paragraphs .22 through .30)

e. Financial information presented in prescribed forms or schedules that require a prescribed form of auditor's reports (paragraphs .32 and .33)

Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles

.02 Generally accepted auditing standards are applicable when an auditor conducts an audit of and reports on any financial statement. A financial statement may be, for example, that of a corporation, a consolidated group of corporations, a combined group of affiliated entities, a not-for-profit organization, a governmental unit, an estate or trust, a partnership, a proprietorship, a segment of any of these, or an individual. The term *financial statement* refers to a presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in conformity with a comprehensive basis of accounting. For reporting purposes, the independent auditor should consider each of the following types of financial presentations to be a financial statement:

a. Balance sheet

b. Statement of income or statement of operations

c. Statement of retained earnings

d. Statement of cash flows
e. Statement of changes in owners' equity
f. Statement of assets and liabilities that does not include owners' equity accounts
g. Statement of revenue and expenses
h. Summary of operations
i. Statement of operations by product lines
j. Statement of cash receipts and disbursements

.03 An independent auditor's judgment concerning the overall presentation of financial statements should be applied within an identifiable framework (see section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles). Normally, the framework is provided by generally accepted accounting principles, and the auditor's judgment in forming an opinion is applied accordingly (see section 411.05). In some circumstances, however, a comprehensive basis of accounting other than generally accepted accounting principles may be used. [Title of section 411 amended, effective for reports issued or reissued on or after June 30, 2001, by Statement on Auditing Standards No. 93.]

.04 For purposes of this section, a comprehensive basis of accounting other than generally accepted accounting principles is one of the following—

a. A basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject. An example is a basis of accounting insurance companies use pursuant to the rules of a state insurance commission.
b. A basis of accounting that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements.
c. The cash receipts and disbursements basis of accounting, and modifications of the cash basis having substantial support, such as recording depreciation on fixed assets or accruing income taxes.
d. A definite set of criteria having substantial support that is applied to all material items appearing in financial statements, such as the price-level basis of accounting.

Unless one of the foregoing descriptions applies, reporting under the provisions of paragraph .05 is not permitted.

Reporting on Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)

.05 When reporting on financial statements prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles, as defined in paragraph .04, an independent auditor should include in the report—

a. A title that includes the word *independent*.[1]
b. A paragraph that—

[1] This section does not require a title for an auditor's report if the auditor is not independent. See section 504, *Association With Financial Statements*, for guidance on reporting when the auditor is not independent.

(1) States that the financial statements identified in the report were audited.

(2) States that the financial statements are the responsibility of the Company's management[2] and that the auditor is responsible for expressing an opinion on the financial statements based on the audit.

c. A paragraph that—

(1) States that the audit was conducted in accordance with generally accepted auditing standards and includes an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards).

(2) States that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

(3) States that an audit includes—

(*a*) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements,

(*b*) Assessing the accounting principles used and significant estimates made by management, and

(*c*) Evaluating the overall financial statement presentation (see paragraph .09).

(4) States that the auditor believes that his or her audit provides a reasonable basis for the opinion.

d. A paragraph that—

(1) States the basis of presentation and refers to the note to the financial statements that describes the basis (see paragraphs .09 and .10).

(2) States that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles.

e. A paragraph that expresses the auditor's opinion (or disclaims an opinion) on whether the financial statements are presented fairly, in all material respects, in conformity with the basis of accounting described. If the auditor concludes that the financial statements are not presented fairly on the basis of accounting described or if there has been a limitation on the scope of the audit, he or she should disclose all the substantive reasons for the conclusion in an explanatory paragraph(s) (preceding the opinion paragraph)

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[2] In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility. However, the statement about management's responsibility should not be further elaborated upon in the auditor's standard report or referenced to management's report.

of the report and should include in the opinion paragraph the appropriate modifying language and a reference to such explanatory paragraph(s).[3]

f. If the financial statements are prepared in conformity with the requirements or financial reporting provisions of a governmental regulatory agency (see paragraph .04*a*), a separate paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity and the regulatory agencies to whose jurisdiction the entity is subject, and is not intended to be and should not be used by anyone other than these specified parties. Such a paragraph is appropriate even though by law or regulation the auditor's report may be made a matter of public record.[4] The auditor may use this form of report only if the financial statements and report are intended solely for use by those within the entity and one or more regulatory agencies to whose jurisdiction the entity is subject.[5]

g. The manual or printed signature of the auditor's firm.

h. The date.[6]

[As amended, effective for audits of financial statements for periods ended on or after December 31, 1996, by Statement on Auditing Standards No. 77. Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

.06 Unless the financial statements meet the conditions for presentation in conformity with a "comprehensive basis of accounting other than generally accepted accounting principles" as defined in paragraph .04, the auditor should use the standard form of report (see section 508, *Reports on Audited Financial Statements*, paragraph .08) modified as appropriate because of the departures from generally accepted accounting principles.

.07 Terms such as *balance sheet, statement of financial position, statement of income, statement of operations*, and *statement of cash flows*, or similar unmodified titles are generally understood to be applicable only to financial statements that are intended to present financial position, results of operations, or cash flows in conformity with generally accepted accounting principles. Consequently, the auditor should consider whether the financial statements that he or she is reporting on are suitably titled. For example, cash basis financial statements might be titled *statement of assets and liabilities arising from cash*

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[3] Paragraph .31 discusses other circumstances that may require that the auditor add additional explanatory language to the special report.

[4] Public record, for purposes of auditor's reports on financial statements of a regulated entity that are prepared in accordance with the financial reporting provisions of a government regulatory agency, includes circumstances in which specific requests must be made by the public to obtain access to or copies of the report. In contrast, the auditor would be precluded from using this form of report in circumstances in which the entity distributes the financial statements to parties other than the regulatory agency either voluntarily or upon specific request. [Footnote added, effective for audits of financial statements for periods ended on or after December 31, 1996, by Statement on Auditing Standards No. 77.]

[5] If the financial statements and report are intended for use by parties other than those within the entity and one or more regulatory agencies to whose jurisdiction the entity is subject, the auditor should follow the guidance in section 544, *Lack of Conformity With Generally Accepted Accounting Principles*. [Footnote renumbered and amended, effective for audits of financial statements for periods ended on or after December 31, 1996, by the issuance of Statement on Auditing Standards No. 77.]

[6] For guidance on dating the auditor's report, see section 530, *Dating of the Independent Auditor's Report*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

transactions, or *statement of revenue collected and expenses paid*, and a financial statement prepared on a statutory or regulatory basis might be titled *statement of income—statutory basis*. If the auditor believes that the financial statements are not suitably titled, the auditor should disclose his or her reservations in an explanatory paragraph of the report and qualify the opinion.

.08 Following are illustrations of reports on financial statements prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles.[7]

Financial Statements Prepared on a Basis Prescribed by a Regulatory Agency Solely for Filing With That Agency

Independent Auditor's Report

We have audited the accompanying statements of admitted assets, liabilities, and surplus—statutory basis of XYZ Insurance Company as of December 31, 20X2 and 20X1, and the related statements of income and cash flows—statutory basis and changes in surplus—statutory basis for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared in conformity with the accounting practices prescribed or permitted by the Insurance Department of [*State*], which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and management of XYZ Insurance Company and [*name of regulatory agency*] and is not intended to be and should not be used by anyone other than these specified parties.

Financial Statements Prepared on the Entity's Income Tax Basis

Independent Auditor's Report

We have audited the accompanying statements of assets, liabilities, and capital—income tax basis of ABC Partnership as of December 31, 20X2 and 20X1, and the related statements of revenue and expenses—income tax basis and of changes in partners' capital accounts—income tax basis for the years then ended. These financial statements are the responsibility of the

[7] [Footnote deleted to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 87.]

Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of accounting the Partnership uses for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and capital of ABC Partnership as of [at] December 31, 20X2 and 20X1, and its revenue and expenses and changes in partners' capital accounts for the years then ended, on the basis of accounting described in Note X.

Financial Statements Prepared on the Cash Basis

Independent Auditor's Report

We have audited the accompanying statements of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of revenue collected and expenses paid for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of cash receipts and disbursements, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities arising from cash transactions of XYZ Company as of December 31, 20X2 and 20X1, and its revenue collected and expenses paid during the years then ended, on the basis of accounting described in Note X.

Evaluating the Adequacy of Disclosure in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting

.09 When reporting on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, the

auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used. The auditor should apply essentially the same criteria to financial statements prepared on an other comprehensive basis of accounting as he or she does to financial statements prepared in conformity with generally accepted accounting principles. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation as discussed in section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, paragraph .04. [Title of section 411 amended, effective for reports issued or reissued on or after June 30, 2001, by Statement on Auditing Standards No. 93.]

.10 Financial statements prepared on an other comprehensive basis of accounting should include, in the accompanying notes, a summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from generally accepted accounting principles. However, the effects of the differences between generally accepted accounting principles and the basis of presentation of the financial statements that the auditor is reporting on need not be quantified. In addition, when the financial statements contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate. For example, financial statements prepared on an income tax basis or a modified cash basis of accounting usually reflect depreciation, long-term debt and owners' equity. Thus, the informative disclosures for depreciation, long-term debt and owners' equity in such financial statements should be comparable to those in financial statements prepared in conformity with generally accepted accounting principles. When evaluating the adequacy of disclosures, the auditor should also consider disclosures related to matters that are not specifically identified on the face of the financial statements, such as (*a*) related party transactions, (*b*) restrictions on assets and owners' equity, (*c*) subsequent events, and (*d*) uncertainties.

Specified Elements, Accounts, or Items of a Financial Statement

.11 An independent auditor may be requested to express an opinion on one or more specified elements, accounts, or items of a financial statement. In such an engagement, the specified element(s), account(s), or item(s) may be presented in the report or in a document accompanying the report. Examples of one or more specified elements, accounts, or items of a financial statement that an auditor may report on based on an audit made in accordance with generally accepted auditing standards include rentals, royalties, a profit participation, or a provision for income taxes.[8]

.12 When expressing an opinion on one or more specified elements, accounts, or items of a financial statement, the auditor should plan and perform the audit and prepare his or her report with a view to the purpose of

[8] See AT section 201, *Agreed-Upon Procedures Engagements*, for guidance when reporting on the results of applying agreed-upon procedures to one or more specified elements, accounts, or items of a financial statement. See AT section 101, *Attest Engagements*, for guidance when reporting on a review of one or more specified elements, accounts, or items of a financial statement. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995. Footnote revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

the engagement. With the exception of the first standard of reporting, the ten generally accepted auditing standards are applicable to any engagement to express an opinion on one or more specified elements, accounts, or items of a financial statement. The first standard of reporting, which requires that the auditor's report state whether the financial statements are presented in conformity with generally accepted accounting principles, is applicable only when the specified elements, accounts, or items of a financial statement are intended to be presented in conformity with generally accepted accounting principles.

.13 An engagement to express an opinion on one or more specified elements, accounts, or items of a financial statement may be undertaken as a separate engagement or in conjunction with an audit of financial statements. In either case, an auditor expresses an opinion on each of the specified elements, accounts, or items encompassed by the auditor's report; therefore, the measurement of materiality must be related to each individual element, account, or item reported on rather than to the aggregate thereof or to the financial statements taken as a whole. Consequently, an audit of a specified element, account, or item for purposes of reporting thereon is usually more extensive than if the same information were being considered in conjunction with an audit of financial statements taken as a whole. Also, many financial statement elements are interrelated, for example, sales and receivables; inventory and payables; and buildings and equipment and depreciation. The auditor should be satisfied that elements, accounts, or items that are interrelated with those on which he or she has been engaged to express an opinion have been considered in expressing an opinion.

.14 The auditor should not express an opinion on specified elements, accounts, or items included in financial statements on which he or she has expressed an adverse opinion or disclaimed an opinion based on an audit, if such reporting would be tantamount to expressing a piecemeal opinion on the financial statements (see section 508, *Reports on Audited Financial Statements*, paragraph .64). However, an auditor would be able to express an opinion on one or more specified elements, accounts, or items of a financial statement provided that the matters to be reported on and the related scope of the audit were not intended to and did not encompass so many elements, accounts, or items as to constitute a major portion of the financial statements. For example, it may be appropriate for an auditor to express an opinion on an entity's accounts receivable balance even if the auditor has disclaimed an opinion on the financial statements taken as a whole. However, the report on the specified element, account, or item should be presented separately from the report on the financial statements of the entity.

Reports on One or More Specified Elements, Accounts, or Items of a Financial Statement

.15 When an independent auditor is engaged to express an opinion on one or more specified elements, accounts, or items of a financial statement, the report should include—

a. A title that includes the word *independent*.[9]

b. A paragraph that—

[9] See footnote 1. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

(1) States that the specified elements, accounts, or items identified in the report were audited. If the audit was made in conjunction with an audit of the company's financial statements, the paragraph should so state and indicate the date of the auditor's report on those financial statements. Furthermore, any departure from the standard report on those statements should also be disclosed if considered relevant to the presentation of the specified element, account or item.

(2) States that the specified elements, accounts, or items are the responsibility of the Company's management and that the auditor is responsible for expressing an opinion on the specified elements, accounts or items based on the audit.

c. A paragraph that—

(1) States that the audit was conducted in accordance with generally accepted auditing standards and includes an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards).

(2) States that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the specified elements, accounts, or items are free of material misstatement.

(3) States that an audit includes—

(*a*) Examining, on a test basis, evidence supporting the amounts and disclosures in the presentation of the specified elements, accounts, or items,

(*b*) Assessing the accounting principles used and significant estimates made by management, and

(*c*) Evaluating the overall presentation of the specified elements, accounts, or items.

(4) States that the auditor believes that his or her audit provides a reasonable basis for the auditor's opinion.

d. A paragraph[10] that—

(1) Describes the basis on which the specified elements, accounts, or items are presented (see paragraphs .09 and .10) and, when applicable, any agreements specifying such basis if the presentation is not prepared in conformity with generally accepted accounting principles.[11] If the presentation is prepared in conformity with generally accepted accounting principles, the paragraph should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles).

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[10] Alternatively, this requirement can be met by incorporating the description in the introductory paragraph discussed in paragraph .15*b* above. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

[11] When the specified element, account, or item is presented in conformity with an other comprehensive basis of accounting, see paragraph .05*d*(2). [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

(2) If considered necessary, includes a description and the source of significant interpretations, if any, made by the Company's management, relating to the provisions of a relevant agreement.

e. A paragraph that expresses the auditor's opinion (or disclaims an opinion) on whether the specified elements, accounts, or items are fairly presented, in all material respects, in conformity with the basis of accounting described. If the auditor concludes that the specified elements, accounts, or items are not presented fairly on the basis of accounting described or if there has been a limitation on the scope of the audit, the auditor should disclose all the substantive reasons for that conclusion in an explanatory paragraph(s) (preceding the opinion paragraph) of the report and should include in the opinion paragraph appropriate modifying language and a reference to such explanatory paragraph(s).[12]

f. If the specified element, account, or item is prepared to comply with the requirements or financial reporting provisions of a contract or agreement that results in a presentation that is not in conformity with either generally accepted accounting principles or an other comprehensive basis of accounting, a separate paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity and the parties to the contract or agreement,[13] and is not intended to be and should not be used by anyone other than these specified parties. Such a restriction on the use of the report is necessary because the basis, assumptions, or purpose of the presentation (contained in the contract or agreement) is developed for and directed only to the parties to the contract or agreement.

g. The manual or printed signature of the auditor's firm.

h. The date.[14]

When expressing an opinion on one or more specified elements, accounts, or items of a financial statement, the auditor, to provide more information as to the scope of the audit, may wish to describe in a separate paragraph certain other auditing procedures applied. However, no modification in the content of paragraph .15*c* above should be made. [Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

.16 If a specified element, account, or item is, or is based upon, an entity's net income or stockholders' equity or the equivalent thereof, the auditor should have audited the complete financial statements to express an opinion on the specified element, account, or item.

.17 The auditor should consider the effect that any departure, including additional explanatory language because of the circumstances discussed in section 508, *Reports on Audited Financial Statements*, paragraph .11, from the

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[12] Paragraph 31 discusses other circumstances that may require that the auditor add additional explanatory language to the special report. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

[13] If the presentation is prepared on a basis prescribed by a governmental regulatory agency (which is also OCBOA), the auditor should restrict the distribution of the report on such presentation. See paragraph .05*f* for further reporting guidance in this situation. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

[14] See footnote 6. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

standard report on the audited financial statements might have on the report on a specified element, account, or item thereof.

.18 Following are illustrations of reports expressing an opinion on one or more specified elements, accounts, or items of a financial statement.

Report Relating to Accounts Receivable

Independent Auditor's Report

We have audited the accompanying schedule of accounts receivable of ABC Company as of December 31, 20X2. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of accounts receivable is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of accounts receivable. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of accounts receivable referred to above presents fairly, in all material respects, the accounts receivable of ABC Company as of December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.[15]

Report Relating to Amount of Sales for the Purpose of Computing Rental

Independent Auditor's Report

We have audited the accompanying schedule of gross sales (as defined in the lease agreement dated March 4, 20XX, between ABC Company, as lessor, and XYZ Stores Corporation, as lessee) of XYZ Stores Corporation at its Main Street store, [*City*], [*State*], for the year ended December 31, 20X2. This schedule is the responsibility of XYZ Stores Corporation's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of gross sales is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of gross sales. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of gross sales referred to above presents fairly, in all material respects, the gross sales of XYZ Stores Corporation at its Main

[15] Since this presentation was prepared in conformity with generally accepted accounting principles, the report need not be restricted. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

Street store, [*City*], [*State*], for the year ended December 31, 20X2, as defined in the lease agreement referred to in the first paragraph.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Stores Corporation and ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

Report Relating to Royalties

Independent Auditor's Report

We have audited the accompanying schedule of royalties applicable to engine production of the Q Division of XYZ Corporation for the year ended December 31, 20X2, under the terms of a license agreement dated May 14, 20XX, between ABC Company and XYZ Corporation. This schedule is the responsibility of XYZ Corporation's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of royalties is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of royalties. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that, under XYZ Corporation's interpretation of the agreement referred to in the first paragraph, royalties were based on the number of engines produced after giving effect to a reduction for production retirements that were scrapped, but without a reduction for field returns that were scrapped, even though the field returns were replaced with new engines without charge to customers.

In our opinion, the schedule of royalties referred to above presents fairly, in all material respects, the number of engines produced by the Q Division of XYZ Corporation during the year ended December 31, 20X2, and the amount of royalties applicable thereto, under the license agreement referred to above.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Corporation and ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

Report on a Profit Participation[16]

Independent Auditor's Report

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company for the year ended December 31, 20X1, and have issued our report thereon dated March 10, 20X2. We have also audited XYZ Company's schedule of John Smith's profit participation for the year ended December 31, 20X1. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this schedule based on our audit.

[16] See paragraph .16. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

We conducted our audit of the schedule in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of profit participation is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that the documents that govern the determination of John Smith's profit participation are (*a*) the employment agreement between John Smith and XYZ Company dated February 1, 20X0, (*b*) the production and distribution agreement between XYZ Company and Television Network Incorporated dated March 1, 20X0, and (*c*) the studio facilities agreement between XYZ Company and QRX Studios dated April 1, 20X0, as amended November 1, 20X0.

In our opinion, the schedule of profit participation referred to above presents fairly, in all material respects, John Smith's participation in the profits of XYZ Company for the year ended December 31, 20X1, in accordance with the provisions of the agreements referred to above.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Company and John Smith and is not intended to be and should not be used by anyone other than these specified parties.

Report on Federal and State Income Taxes Included in Financial Statements[17]

Independent Auditor's Report

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company, Inc., for the year ended June 30, 20XX, and have issued our report thereon dated August 15, 20XX. We have also audited the current and deferred provision for the Company's federal and state income taxes for the year ended June 30, 20XX, included in those financial statements, and the related asset and liability tax accounts as of June 30, 20XX. This income tax information is the responsibility of the Company's management. Our responsibility is to express an opinion on it based on our audit.

We conducted our audit of the income tax information in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the federal and state income tax accounts are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures related to the federal and state income tax accounts. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the federal and state income tax accounts. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the Company has paid or, in all material respects, made adequate provision in the financial statements referred to above for the payment of all federal and state income taxes and for related deferred income taxes that could

[17] See paragraph .16. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

be reasonably estimated at the time of our audit of the financial statements of XYZ Company, Inc., for the year ended June 30, 20XX.

[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

Compliance With Aspects of Contractual Agreements or Regulatory Requirements Related to Audited Financial Statements

.19 Entities may be required by contractual agreements, such as certain bond indentures and loan agreements, or by regulatory agencies to furnish compliance reports by independent auditors.[18] For example, loan agreements often impose on borrowers a variety of obligations involving matters such as payments into sinking funds, payments of interest, maintenance of current ratios, and restrictions of dividend payments. They usually also require the borrower to furnish annual financial statements that have been audited by an independent auditor. In some instances, the lenders or their trustees may request assurance from the independent auditor that the borrower has complied with certain covenants of the agreement relating to accounting matters. The independent auditor may satisfy this request by giving negative assurance relative to the applicable covenants based on the audit of the financial statements. This assurance may be given in a separate report or in one or more paragraphs of the auditor's report accompanying the financial statements. Such assurance, however, should not be given unless the auditor has audited the financial statements to which the contractual agreements or regulatory requirements relate and should not extend to covenants that relate to matters that have not been subjected to the audit procedures applied in the audit of the financial statements.[19] In addition, such assurance should not be given if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements to which these covenants relate.

.20 When an auditor's report on compliance with contractual agreements or regulatory provisions is being given in a separate report, the report should include—

a. A title that includes the word *independent*.[20]

b. A paragraph that states the financial statements were audited in accordance with generally accepted auditing standards and includes an identification of the United States of America as the

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[18] When the auditor is engaged to test compliance with laws and regulations in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States (Yellow Book), he or she should follow guidance contained in section 801, *Compliance Auditing Applicable to Governmental Entities and Other Specified Recipients of Governmental Financial Assistance*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

[19] When the auditor is engaged to provide assurance on compliance with contractual agreements or regulatory provisions that relate to matters that have not been subjected to the audit procedures applied in the audit of the financial statements, the auditor should refer to the guidance in AT section 601, *Compliance Attestation*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995. Footnote revised, February 1997, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 3. Footnote revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

[20] See footnote 1. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards) and the date of the auditor's report on those financial statements. Furthermore, any departure from the standard report on those statements should also be disclosed.

c. A paragraph that includes a reference to the specific covenants or paragraphs of the agreement, provides negative assurance relative to compliance with the applicable covenants of the agreement insofar as they relate to accounting matters, and specifies that the negative assurance is being given in connection with the audit of the financial statements. The auditor should ordinarily state that the audit was not directed primarily toward obtaining knowledge regarding compliance.

d. A paragraph that includes a description and the source of significant interpretations, if any, made by the Company's management relating to the provisions of a relevant agreement.

e. A separate paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity and the parties to the contract or agreement or the regulatory agency with which the report is being filed, and is not intended to be and should not be used by anyone other than these specified parties. Such a restriction on the use of the report is necessary because the basis, assumptions, or purpose of such presentations (contained in such contracts, agreements, or regulatory provisions) are developed for and directed only to the parties to the contract or agreement, or regulatory agency responsible for the provisions.

f. The manual or printed signature of the auditor's firm.

g. The date.[21]

[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

.21 When an auditor's report on compliance with contractual agreements or regulatory provisions is included in the report that expresses the auditor's opinion on the financial statements, the auditor should include a paragraph, after the opinion paragraph, that provides negative assurance relative to compliance with the applicable covenants of the agreement, insofar as they relate to accounting matters, and that specifies the negative assurance is being given in connection with the audit of the financial statements. The auditor should also ordinarily state that the audit was not directed primarily toward obtaining knowledge regarding compliance. In addition, the report should include a paragraph that includes a description and source of any significant interpretations made by the entity's management as discussed in paragraph .20*d* as well as a paragraph that restricts the use of the report to the specified parties as discussed in paragraph .20*e*. Following are examples of reports that might be issued:

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[21] See footnote 6. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

Report on Compliance With Contractual Provisions Given in a Separate Report[22]

Independent Auditor's Report

We have audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheet of XYZ Company as of December 31, 20X2, and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated February 16, 20X3.

In connection with our audit, nothing came to our attention that caused us to believe that the Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to XX, inclusive, of the Indenture dated July 21, 20X0, with ABC Bank insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the boards of directors and management of XYZ Company and ABC Bank and is not intended to be and should not be used by anyone other than these specified parties.

Report on Compliance With Regulatory Requirements Given in a Separate Report When the Auditor's Report on the Financial Statements Included an Explanatory Paragraph Because of an Uncertainty

Independent Auditor's Report

We have audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheet of XYZ Company as of December 31, 20X2, and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated March 5, 20X3, which included an explanatory paragraph that described the litigation discussed in Note X of those statements.

In connection with our audit, nothing came to our attention that caused us to believe that the Company failed to comply with the accounting provisions in sections (1), (2) and (3) of the [name of state regulatory agency]. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the board of directors and managements of XYZ Company and the [name of state regulatory agency] and is not intended to be and should not be used by anyone other than these specified parties.

[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

[22] When the auditor's report on compliance with contractual agreements or regulatory provisions is included in the report that expresses the auditor's opinion on the financial statements, the last two paragraphs of this report are examples of the paragraphs that should follow the opinion paragraph of the auditor's report on the financial statements. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

Special-Purpose Financial Presentations to Comply With Contractual Agreements or Regulatory Provisions

.22 An auditor is sometimes asked to report on special-purpose financial statements prepared to comply with a contractual agreement[23] or regulatory provisions. In most circumstances, these types of presentations are intended solely for the use of the parties to the agreement, regulatory bodies, or other specified parties. This section discusses reporting on these types of presentations, which include the following:

a. A special-purpose financial presentation prepared in compliance with a contractual agreement or regulatory provision that does not constitute a complete presentation of the entity's assets, liabilities, revenues and expenses, but is otherwise prepared in conformity with generally accepted accounting principles or an other comprehensive basis of accounting (paragraphs .23 through .26).

b. A special-purpose financial presentation (may be a complete set of financial statements or a single financial statement) prepared on a basis of accounting prescribed in an agreement that does not result in a presentation in conformity with generally accepted accounting principles or an other comprehensive basis of accounting (paragraphs .27 through .30).

Financial Statements Prepared on a Basis of Accounting Prescribed in a Contractual Agreement or Regulatory Provision That Results in an Incomplete Presentation But One That is Otherwise in Conformity With Generally Accepted Accounting Principles or an Other Comprehensive Basis of Accounting

.23 A governmental agency may require a schedule of gross income and certain expenses of an entity's real estate operation in which income and expenses are measured in conformity with generally accepted accounting principles, but expenses are defined to exclude certain items such as interest, depreciation, and income taxes. Such a schedule may also present the excess of gross income over defined expenses. Also, a buy-sell agreement may specify a schedule of gross assets and liabilities of the entity measured in conformity with generally accepted accounting principles, but limited to the assets to be sold and liabilities to be transferred pursuant to the agreement.

.24 Paragraph .02 of this section defines the term *financial statement* and includes a list of financial presentations that an auditor should consider to be financial statements for reporting purposes. The concept of specified elements, accounts, or items of a financial statement discussed in paragraphs .11 through .18, on the other hand, refers to accounting information that is part of, but significantly less than, a financial statement. The financial presentations described above and similar presentations should generally be regarded as financial statements, even though, as indicated above, certain items may be excluded. Thus, when the auditor is asked to report on these types of presentations, the measurement of materiality for purposes of expressing an opinion

[23] A contractual agreement as discussed in this section is an agreement between the client and one or more third parties other than the auditor. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

should be related to the presentations taken as a whole (see section 312, *Audit Risk and Materiality in Conducting an Audit*). Further, the presentations should differ from complete financial statements only to the extent necessary to meet special purposes for which they were prepared. In addition, when these financial presentations contain items that are the same as, or similar to, those contained in a full set of financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate (see paragraphs .09 and .10). The auditor should also be satisfied that the financial statements presented are suitably titled to avoid any implication that the special-purpose financial statements on which he or she is reporting are intended to present financial position, results of operations, or cash flows.

.25 When the auditor is asked to report on financial statements prepared on a basis of accounting prescribed in a contractual agreement or regulatory provision that results in an incomplete presentation but one that is otherwise in conformity with generally accepted accounting principles or an other comprehensive basis of accounting, the auditor's report should include—

a. A title that includes the word *independent*.[24]

b. A paragraph that—

(1) States that the financial statements identified in the report were audited.

(2) States that the financial statements are the responsibility of the Company's management[25] and that the auditor is responsible for expressing an opinion on the financial statements based on the audit.[26]

c. A paragraph that—

(1) States that the audit was conducted in accordance with generally accepted auditing standards and includes an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards).

(2) States that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

(3) States that an audit includes—

(a) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements,

(b) Assessing the accounting principles used and significant estimates made by management, and

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[24] See footnote 1. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

[25] Sometimes the auditor's client may not be the person responsible for the financial statements on which the auditor is reporting. For example, when the auditor is engaged by the buyer to report on the seller's financial statements prepared in conformity with a buy-sell agreement, the person responsible for the financial statements may be the seller's management. In this case, the wording of this statement should be changed to clearly identify the party that is responsible for the financial statements reported on. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

[26] See footnote 2. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

(c) Evaluating the overall financial statement presentation.

(4) States that the auditor believes that the audit provides a reasonable basis for his or her opinion.

d. A paragraph that—

(1) Explains what the presentation is intended to present and refers to the note to the special-purpose financial statements that describes the basis of presentation (see paragraphs .09 and .10).

(2) If the basis of presentation is in conformity with generally accepted accounting principles, states that the presentation is not intended to be a complete presentation of the entity's assets, liabilities, revenues and expenses.[27]

e. A paragraph that expresses the auditor's opinion (or disclaims an opinion) related to the fair presentation, in all material respects, of the information the presentation is intended to present in conformity with generally accepted accounting principles or an other comprehensive basis of accounting. If the presentation is prepared in conformity with generally accepted accounting principles, the paragraph should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles). If the auditor concludes that the information the presentation is intended to present is not presented fairly on the basis of accounting described or if there has been a limitation on the scope of the audit, the auditor should disclose all the substantive reasons for that conclusion in an explanatory paragraph(s) (preceding the opinion paragraph) of the report and should include in the opinion paragraph appropriate modifying language and a reference to such explanatory paragraph(s).[28]

f. A separate paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity, the parties to the contract or agreement, the regulatory agency with which the report is being filed, or those with whom the entity is negotiating directly, and is not intended to be and should not be used by anyone other than these specified parties. However, such a paragraph is not appropriate if the report and related financial presentation are to be filed with a regulatory agency, such as the Securities and Exchange Commission, and are to be included in a document (such as a prospectus) that is distributed to the general public.

g. The manual or printed signature of the auditor's firm.

h. The date.[29]

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[27] If the basis of presentation is an other comprehensive basis of accounting, the paragraph should state that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles and that it is not intended to be a complete presentation of the entity's assets, liabilities, revenues and expenses on the basis described. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

[28] Paragraph .31 discusses other circumstances that may require that the auditor add additional explanatory language to the special report. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

[29] See footnote 6. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

.26 The following examples illustrate reports expressing an opinion on such special-purpose financial statements:

Report on a Schedule of Gross Income and Certain Expenses to Meet a Regulatory Requirement and to Be Included in a Document Distributed to the General Public

Independent Auditor's Report

We have audited the accompanying Historical Summaries of Gross Income and Direct Operating Expenses of ABC Apartments, City, State (Historical Summaries), for each of the three years in the period ended December 31, 20XX. These Historical Summaries are the responsibility of the Apartments' management. Our responsibility is to express an opinion on the Historical Summaries based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Historical Summaries are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Historical Summaries. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Historical Summaries. We believe that our audits provide a reasonable basis for our opinion.

The accompanying Historical Summaries were prepared for the purpose of complying with the rules and regulations of the Securities and Exchange Commission (for inclusion in the registration statement on Form S-11 of DEF Corporation) as described in Note X and are not intended to be a complete presentation of the Apartments' revenues and expenses.

In our opinion, the Historical Summaries referred to above present fairly, in all material respects, the gross income and direct operating expenses described in Note X of ABC Apartments for each of the three years in the period ended December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

Report on a Statement of Assets Sold and Liabilities Transferred to Comply With a Contractual Agreement

Independent Auditor's Report

We have audited the accompanying statement of net assets sold of ABC Company as of June 8, 20XX. This statement of net assets sold is the responsibility of ABC Company's management. Our responsibility is to express an opinion on the statement of net assets sold based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the statement of net assets sold is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statement of net assets sold. We believe that our audit provides a reasonable basis for our opinion.

The accompanying statement was prepared to present the net assets of ABC Company sold to XYZ Corporation pursuant to the purchase agreement described in Note X, and is not intended to be a complete presentation of ABC Company's assets and liabilities.

In our opinion, the accompanying statement of net assets sold presents fairly, in all material respects, the net assets of ABC Company as of June 8, 20XX sold pursuant to the purchase agreement referred to in Note X, in conformity with accounting principles generally accepted in the United States of America.

This report is intended solely for the information and use of the boards of directors and managements of ABC Company and XYZ Corporation and is not intended to be and should not be used by anyone other than these specified parties.

[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

Financial Statements Prepared on a Basis of Accounting Prescribed in an Agreement That Results in a Presentation That is not in Conformity With Generally Accepted Accounting Principles or an Other Comprehensive Basis of Accounting

.27 The auditor may be asked to report on special-purpose financial statements prepared in conformity with a basis of accounting that departs from generally accepted accounting principles or an other comprehensive basis of accounting. A loan agreement, for example, may require the borrower to prepare consolidated financial statements in which assets, such as inventory, are presented on a basis that is not in conformity with generally accepted accounting principles or an other comprehensive basis of accounting. An acquisition agreement may require the financial statements of the entity being acquired (or a segment of it) to be prepared in conformity with generally accepted accounting principles except for certain assets, such as receivables, inventories, and properties for which a valuation basis is specified in the agreement.

.28 Financial statements prepared under a basis of accounting as discussed above are not considered to be prepared in conformity with a "comprehensive basis of accounting" as contemplated by paragraph .04 of this section because the criteria used to prepare such financial statements do not meet the requirement of being "criteria having substantial support," even though the criteria are definite.

.29 When an auditor is asked to report on these types of financial presentations, the report should include—

a. A title that includes the word *independent*.[30]

b. A paragraph that—

(1) States that the special-purpose financial statements identified in the report were audited.

(2) States that the financial statements are the responsibility of the Company's management[31] and that the auditor

[30] See footnote 1. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

[31] See footnote 25. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

is responsible for expressing an opinion on the financial statements based on the audit.[32]

c. A paragraph that—

(1) States that the audit was conducted in accordance with generally accepted auditing standards and includes an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards).

(2) States that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

(3) States that an audit includes—

(*a*) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements,

(*b*) Assessing the accounting principles used and significant estimates made by management, and

(*c*) Evaluating the overall financial statement presentation.

(4) States that the auditor believes that the audit provides a reasonable basis for the auditor's opinion.

d. A paragraph that—

(1) Explains what the presentation is intended to present and refers to the note to the special-purpose financial statements that describes the basis of presentation (see paragraphs .09 and .10).

(2) States that the presentation is not intended to be a presentation in conformity with generally accepted accounting principles.

e. A paragraph that includes a description and the source of significant interpretations, if any, made by the Company's management relating to the provisions of a relevant agreement.

f. A paragraph that expresses the auditor's opinion (or disclaims an opinion) related to the fair presentation, in all material respects, of the information the presentation is intended to present on the basis of accounting specified. If the auditor concludes that the information the presentation is intended to present is not presented fairly on the basis of accounting described or if there has been a limitation on the scope of the audit, the auditor should disclose all the substantive reasons for that conclusion in an explanatory paragraph(s) (preceding the opinion paragraph) of the report and should include in the opinion paragraph appropriate modifying language and a reference to such explanatory paragraph(s).[33]

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[32] See footnote 2. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

[33] Paragraph .31 discusses other circumstances that may require that the auditor add additional explanatory language to the special report. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

g. A separate paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity, the parties to the contract or agreement, the regulatory agency with which the report is being filed, or those with whom the entity is negotiating directly, and is not intended to be and should not be used by anyone other than these specified parties. For example, if the financial statements have been prepared for the specified purpose of obtaining bank financing, the report's use should be restricted to the various banks with whom the entity is negotiating the proposed financing.

h. The manual or printed signature of the auditor's firm.

i. The date.[34]

[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

.30 The following example illustrates reporting on special-purpose financial statements that have been prepared pursuant to a loan agreement:

Report on Financial Statements Prepared Pursuant to a Loan Agreement That Results in a Presentation not in Conformity With Generally Accepted Accounting Principles or an Other Comprehensive Basis of Accounting

Independent Auditor's Report

We have audited the special-purpose statement of assets and liabilities of ABC Company as of December 31, 20X2 and 20X1, and the related special-purpose statements of revenues and expenses and of cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The accompanying special-purpose financial statements were prepared for the purpose of complying with Section 4 of a loan agreement between DEF Bank and the Company as discussed in Note X, and are not intended to be a presentation in conformity with generally accepted accounting principles.

In our opinion, the special-purpose financial statements referred to above present fairly, in all material respects, the assets and liabilities of ABC Company at December 31, 20X2 and 20X1, and the revenues, expenses and cash flows for the years then ended, on the basis of accounting described in Note X.

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[34] See footnote 6. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

This report is intended solely for the information and use of the boards of directors and management of ABC Company and DEF Bank and is not intended to be and should not be used by anyone other than these specified parties.

[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

Circumstances Requiring Explanatory Language in an Auditor's Special Report

.31 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add additional explanatory language to the special report. These circumstances include the following:

a. Lack of Consistency in Accounting Principles. If there has been a change in accounting principles or in the method of their application,[35] the auditor should add an explanatory paragraph to the report (following the opinion paragraph) that describes the change and refers to the note to the financial presentation (or specified elements, accounts, or items thereof) that discusses the change and its effect thereon[36] if the accounting change is considered relevant to the presentation. Guidance on reporting in this situation is contained in section 508, *Reports on Audited Financial Statements*, paragraphs .16 through .18.[37–38]

b. Going Concern Uncertainties. If the auditor has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the financial statement, the auditor should add an explanatory paragraph after the opinion paragraph of the report only if the auditor's substantial doubt is relevant to the presentation.[39]

c. Other Auditors. When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, the auditor should disclose that fact in the introductory paragraph of the report and should refer to the report of the other auditors in expressing his or her opinion. Guidance on reporting in this situation is contained in section 508, *Reports on Audited Financial Statements*, paragraphs .12 and .13.

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[35] When financial statements (or specified elements, accounts, or items thereof) have been prepared in conformity with generally accepted accounting principles in prior years, and the entity changes its method of presentation in the current year by preparing its financial statements in conformity with an other comprehensive basis of accounting, the auditor need not follow the reporting guidance in this subparagraph. However, the auditor may wish to add an explanatory paragraph to the report to highlight (1) a difference in the basis of presentation from that used in prior years or (2) that another report has been issued on the entity's financial statements prepared in conformity with another basis of presentation (for example, when cash basis financial statements are issued in addition to GAAP financial statements). [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

[36] A change in the tax law is not considered to be a change in accounting principle for which the auditor would need to add an explanatory paragraph, although disclosure may be necessary. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

[37–38] [Footnotes deleted to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 79.]

[39] See section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* for a report example when the auditor has substantial doubt about the entity's ability to continue as a going concern. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

d. Comparative Financial Statements (or Specified Elements, Accounts, or Items Thereof). If the auditor expresses an opinion on prior-period financial statements (or specified elements, accounts, or items thereof) that is different from the opinion he or she previously expressed on that same information, the auditor should disclose all of the substantive reasons for the different opinion in a separate explanatory paragraph preceding the opinion paragraph of the report. Guidance on reporting in this situation is contained in section 508, *Reports on Audited Financial Statements*, paragraphs .68 and .69.

As in reports on financial statements prepared in conformity with generally accepted accounting principles, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (or specified elements, accounts, or items thereof). [Revised, February 1997, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 79.]

Financial Information Presented in Prescribed Forms or Schedules

.32 Printed forms or schedules designed or adopted by the bodies with which they are to be filed often prescribe the wording of an auditor's report. Many of these forms are not acceptable to independent auditors because the prescribed form of auditor's report does not conform to the applicable professional reporting standards. For example, the prescribed language of the report may call for statements by the auditor that are not consistent with the auditor's function or responsibility.

.33 Some report forms can be made acceptable by inserting additional wording; others can be made acceptable only by complete revision. When a printed report form calls upon an independent auditor to make a statement that he or she is not justified in making, the auditor should reword the form or attach a separate report. In those situations, the reporting provisions of paragraph .05 may be appropriate.

Effective Date

.34 This section is effective for reports issued on or after July 1, 1989. Early application of the provisions of this section is permissible.

AU Section 9623

Special Reports: Auditing Interpretations of Section 623

[1.] Auditor's Report Under Employee Retirement Income Security Act of 1974

[.01–.08] [Withdrawn February 1983.*]

[2.] Reports on Elements, Accounts, or Items of a Financial Statement That Are Presented in Conformity with GAAP

[.09–.10] [Withdrawn March 1989, by SAS No. 62. (See section 623.)]

[3.] Compliance With the Foreign Corrupt Practices Act of 1977

[.11–.14] [Transferred to section 9642; Deleted October 1993.] (See the guidance provided in SSAE No. 10, chapter 5, paragraph 5.82 (AT section 501.82).) [Revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

[4.] Reports on Engagements Solely to Meet State Regulatory Examination Requirements

[.15–.16] [Deleted April 1981 by SAS No. 35, as superseded by SAS No. 75, as superseded by SAS No. 93.] (See section 622.) [Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

[5.] Financial Statements Prepared in Accordance with Accounting Practices Specified in an Agreement

[.17–.25] [Withdrawn March 1989, by SAS No. 62. (See section 623.)]

[6.] Reporting on Special-Purpose Financial Presentations[3–4]

[.26–.31] [Withdrawn March 1989, by SAS No. 62. (See section 623.)]

[7.] Understanding of Agreed-Upon Procedures

[.32–.33] [Deleted April 1981 by SAS No. 35, as superseded by SAS No. 75, as superseded by SAS No. 93.] (See section 622.) [Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

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* See Audit and Accounting Guide *Employee Benefit Plans.*

[3–4] [Footnotes deleted.]

[8.] Adequacy of Disclosure in Financial Statements Prepared on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles

[.34–.39] [Withdrawn March 1989, by SAS No. 62. (See section 623.)]

9. Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves

.40 *Question*—The instructions to the statutory annual statement to be filed by property and liability insurance companies with state regulatory agencies include the following:

If a company is required by its domiciliary commissioner, there is to be submitted to the commissioner as an addendum to the Annual Statement by April 1 of the subsequent year a statement of a qualified loss reserve specialist setting forth his or her opinion relating to loss and loss adjustment expense reserves.

The term "qualified loss reserve specialist" includes an independent auditor who has competency in loss reserve evaluation.

.41 If an independent auditor who has made an audit of the insurance company's financial statements in accordance with generally accepted auditing standards is engaged to express a separate opinion on the company's loss and loss adjustment expense reserves for the purpose of compliance with the above instruction, what form of report should be used by the independent auditor?

.42 *Interpretation*—Section 623.11 through .18 provides guidance on auditors' reports expressing an opinion on one or more specified elements, accounts, or items of a financial statement. Following are illustrations of the auditor's report expressing an opinion on a company's loss and loss adjustment expense reserves and the schedule of liabilities for losses and loss adjustment expenses that would accompany the report.[5]

Illustrative report

Board of Directors

X Insurance Company

We are members of the American Institute of Certified Public Accountants (AICPA) and are the independent public accountants of X Insurance Company. We acknowledge our responsibility under the AICPA's Code of Professional Conduct to undertake only those engagements which we can complete with professional competence.

We have audited the financial statements prepared in conformity with accounting principles generally accepted in the United States of America [*or prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of .....*] of X Insurance Company as of

[5] If a significant period of time has elapsed between the date of the report on the financial statements and the date he is reporting on the loss and loss adjustment expense reserves, the auditor may wish to include the following paragraph after the opinion paragraph: Because we have not audited any financial statements of X Insurance Company as of any date or for any period subsequent to December 31, 20X0, we have no knowledge of the effects, if any, on the liability for unpaid losses and unpaid loss adjustment expenses of events that may have occurred subsequent to the date of our audit.

December 31, 20X0, and have issued our report thereon dated March 1, 19X1. In the course of our audit, we have audited the estimated liabilities for unpaid losses and unpaid loss adjustment expenses of X Insurance Company as of December 31, 20X0, as set forth in the accompanying schedule including consideration of the assumptions and methods relating to the estimation of such liabilities.

In our opinion, the accompanying schedule presents fairly, in all material respects, the estimated unpaid losses and unpaid loss adjustment expenses of X Insurance Company that could be reasonably estimated at December 31, 20X0, in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of ..... on a basis consistent with that of the preceding year.

This report is intended solely for the information and use of the board of directors and management of X Insurance Company and [*the state regulatory agencies to whose jurisdiction the entity is subject*] and is not intended to be and should not be used by anyone other than these specified parties.

Signature

Date

X Insurance Company
Schedule of Liabilities for Losses
and Loss Adjustment Expenses
December 31, 19X0

Liability for losses	$xx,xxx,xxx
Liability for loss adjustment expenses	x,xxx,xxx
Total	$xx,xxx,xxx

Note 1—Basis of presentation

The above schedule has been prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of ..... (Significant differences between statutory practices and generally accepted accounting principles for the calculation of the above amounts should be described but the monetary effect of any such differences need not be stated.)

Losses and loss adjustment expenses are provided for when incurred in accordance with the applicable requirements of the insurance laws [and/or regulations] of the State of ..... Such provisions include (1) individual case estimates for reported losses, (2) estimates received from other insurers with respect to reinsurance assumed, (3) estimates for unreported losses based on past experience modified for current trends, and (4) estimates of expenses for investigating and settling claims.

Note 2—Reinsurance

The Company reinsures certain portions of its liability insurance coverages to limit the amount of loss on individual claims and purchases catastrophe insurance to protect against aggregate single occurrence losses. Certain portions of property insurance are reinsured on a quota share basis.

The liability for losses and the liability for loss adjustment expenses were reduced by $xxx,xxx and $xxx,xxx, respectively, for reinsurance ceded to other companies.

Contingent liability exists with respect to reinsurance which would become an actual liability in the event the reinsuring companies, or any of them, might be unable to meet their obligations to the Company under existing reinsurance agreements.

.43 *Question*—The instructions to the statutory annual statement also include the following:

> If there has been any material change in the assumptions and/or methods from those previously employed, that change should be described in the statement of opinion by inserting a phrase such as:
>
> A material change in assumptions (and/or methods) was made during the past year, but such change accords with accepted loss reserving standards.

A brief description of the change should follow.

.44 In what circumstances is it appropriate for the independent auditor to modify his special report on loss and loss adjustment expense reserves for material changes in assumptions and/or methods?

.45 *Interpretation*—Section 420.06 states that changes in accounting principles and methods of applying them affect consistency and require the addition of an explanatory paragraph (following the opinion paragraph) in the auditor's report on the audited financial statements. Section 623.16 states that, if applicable, any departures from the auditor's standard report on the related financial statements should be indicated in the special report on an element, account, or item of a financial statement.

.46 Section 420.16 states that a change in accounting estimate is not a change affecting consistency requiring recognition in the auditor's report. However, such changes in estimates that are disclosed in the financial statements on which the auditor has reported should also be disclosed in the notes to the schedule of liabilities for unpaid losses and unpaid loss adjustment expenses accompanying the auditor's special report. (See APB Opinion No. 20, *Accounting Changes*, paragraph 33 [AC section A06.132].)

[Issue Date: May, 1981; Revised: February, 1999; Revised: October, 2000.]

10. Reports on the Financial Statements Included in Internal Revenue Form 990, "Return of Organizations Exempt From Income Tax"

.47 *Question*—Internal Revenue Form 990, "Return of Organizations Exempt from Income Tax," may be used as a uniform annual report by charitable organizations in some states for reporting to both state and federal governments. Many states require an auditor's opinion on whether the financial statements included in the report[6] are presented fairly in conformity with generally accepted accounting principles. Ordinarily, financial statements included in a Form 990 used by a charitable organization as a uniform annual report may be expected to contain certain material departures from the accounting principles in the AICPA Audit and Accounting Guides *Health Care Organizations* and *Not-for-Profit Organizations*.

.48 In most states the report is used primarily to satisfy statutory requirements, but regulatory authorities make the financial statements and the accompanying auditor's report a matter of public record. In some situations, however, there may be public distribution of the report. What should be the form of the auditor's report in each of the above situations?

.49 *Interpretation*—In both situations, the auditor should first consider whether the financial statements (including appropriate notes to financial

[6] As used in this interpretation, the report refers to a Form 990 report by a charitable organization in a filing with a government agency.

statements) are in conformity with generally accepted accounting principles. If they are, the auditor can express an unqualified opinion.

.50 If the financial statements are not in conformity with generally accepted accounting principles, the auditor should consider the distribution of the report to determine whether it is appropriate to issue a special report (as illustrated in section 623, *Special Reports*, paragraph .08, for reporting on financial statements prepared in accordance with the requirements or financial reporting provisions of a government regulatory agency).

.51 Section 623 permits this type of special report only if the financial statements and report are intended solely for use by those within the entity and one or more regulatory agencies to whose jurisdiction the entity is subject. However, section 623 makes this form of reporting appropriate, even though by law or regulation the accountant's report may be made a matter of public record.[7]

.52 The following example illustrates a report expressing an opinion on such special purpose financial statements:

Independent Auditor's Report

We have audited the balance sheet (Part IV) of XYZ Charity as of December 31, 20XX, and the related statement of revenue, expenses and changes in net assets (Part I) and statement of functional expenses (Part II) for the year then ended included in the accompanying Internal Revenue Service Form 990. These financial statements are the responsibility of Charity's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared in conformity with the accounting practices prescribed by the Internal Revenue Service and the Office of the State of ....., which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities and fund balances of XYZ Charity as of December 31, 19XX and its revenue and expenses and changes in fund balances for the year then ended on the basis of accounting described in Note X.[8]

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[7] *Public record*, for purposes of auditors' reports in states with filing requirements for exempt organizations, includes circumstances in which specific requests must be made by the public to obtain access to or copies of the report, notwithstanding the fact that some states may advertise or require the exempt organization to advertise the availability of Form 990. In contrast, *public distribution*, for purposes of auditors' reports in state filings on various Forms 990 dealing with exempt organizations, includes circumstances in which the regulatory agency or the exempt organization, either because of regulatory requirements or voluntarily, distributes copies of Form 990 to contributors or others without receiving a specific request for such distribution.

[8] [Footnote deleted.]

Our audit was made for the purpose of forming an opinion on the above financial statements taken as a whole. The accompanying information on pages ..... to ..... is presented for purposes of additional analysis and is not a required part of the above financial statements. Such information, except for that portion marked "unaudited," on which we express no opinion, has been subjected to the auditing procedures applied in the audit of the above financial statements; and, in our opinion, the information is fairly stated in all material respects in relation to the financial statements taken as a whole.

This report is intended solely for the information and use of the board of directors and management of XYZ Charity, the Internal Revenue Service, and the Office of the State of ..... and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

.53 If there is public distribution[9] of the report, because the law requires it or otherwise (copies of Form 990 are distributed to contributors or others without receiving a specific request for such distribution) and the financial statements included in it are not in conformity with generally accepted accounting principles, a special report (as illustrated in section 623.08) is not appropriate. In such cases, the auditor should express a qualified or adverse opinion and disclose the effects on the financial statements of the departures from generally accepted accounting principles if the effects are reasonably determinable. If the effects are not reasonably determinable, the report should so state.

[.54] [Paragraph deleted to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 87.]

[Issue Date: December, 1991; Revised: February, 1997; Revised: February, 1999; Revised: October 2000.]

11. Reporting on Current-Value Financial Statements That Supplement Historical-Cost Financial Statements in Presentations of Real Estate Entities

.55 *Question*—A real estate entity presents current-value financial statements[10] to supplement historical-cost financial statements. May an auditor accept an engagement to report on current-value financial statements that supplement historical-cost financial statements, and if so, how should the auditor report?

.56 *Interpretation*—An auditor may accept an engagement to report on current-value financial statements that supplement historical-cost financial

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[9] Auditors should consider whether there is a public distribution requirement by reference to the relevant state law. However, at this time (April 1982), most state laws do not contain a public distribution requirement and a special report is ordinarily appropriate. For example, the laws of New York, New Jersey and Connecticut do not presently require public distribution as defined by this interpretation.

[10] Generally accepted accounting principles require the use of current-value accounting for financial statements of certain types of entities (for example, investment companies, employee benefit plans, personal financial statements, and mutual and common trust funds). This interpretation does not apply to reports on current-value financial statements of such entities. The auditor engaged to report on current-value financial statements of such entities should follow the guidance in section 508, *Reports on Audited Financial Statements*, and the applicable industry audit guide.

statements of a real estate entity only if the auditor believes the following two conditions exist—

- the measurement and disclosure criteria used to prepare the current-value financial statements are reasonable, and
- competent persons using the measurement and disclosure criteria would ordinarily obtain materially similar measurements or disclosures.

.57 If these conditions are satisfied, an auditor may report on such current-value financial statements in a manner similar to that discussed in section 623, *Special Reports*, paragraph .29. However, because the current-value financial statements only supplement the historical-cost financial statements and are not presented as a stand-alone presentation, it is not necessary to restrict the use of the auditor's report on the presentation as required by that paragraph.

.58 The following is an example of a report an auditor might issue when reporting on current-value financial statements that supplement historical-cost financial statements of a real estate entity:

Independent Auditor's Report

We have audited the accompanying historical-cost balance sheets of X Company as of December 31, 20X3 and 20X2, and the related historical-cost statements of income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 20X3. We also have audited the supplemental current-value balance sheets of X Company as of December 31, 20X3 and 20X2, and the related supplemental current-value statements of income and shareholders' equity for each of the three years in the period ended December 31, 20X3. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the historical-cost financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X3, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 1, the supplemental current-value financial statements have been prepared by management to present relevant financial information that is not provided by the historical-cost financial statements and are not intended to be a presentation in conformity with generally accepted accounting principles. In addition, the supplemental current-value financial statements do not purport to present the net realizable, liquidation, or market value of the Company as a whole. Furthermore, amounts ultimately realized by the Company from the disposal of properties may vary significantly from the current values presented.

In our opinion, the supplemental current-value financial statements referred to above present fairly, in all material respects, the information set forth in them on the basis of accounting described in Note 1.

[*Signature*]

[*Date*]

.59 The auditor should also consider the adequacy of disclosures relating to the current value financial statements. Such disclosures should describe the accounting policies applied and such matters as the basis of presentation, nature of the reporting entity's properties, status of construction-in-process, valuation bases used for each classification of assets and liabilities, and sources of valuation. These matters should be disclosed in the notes in a sufficiently clear and comprehensive manner that enables a knowledgeable reader to understand the current-value financial statements.

[Issue Date: July, 1990; Revised: February, 1999; Revised: October, 2000.]

12. Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis

.60 *Question*—Insurance enterprises issue financial statements prepared in accordance with accounting practices prescribed or permitted by insurance regulators (a cstatutory basisd) in addition to, or instead of, financial statements prepared in accordance with generally accepted accounting principles (GAAP). Effective January 1, 2001, most states are expected to adopt a comprehensively updated *Accounting Practices and Procedures Manual*, as revised by the National Association of Insurance Commissioners' (NAIC's) Codification project. The updated *Accounting Practices and Procedures Manual*, along with any subsequent revisions, is referred to as the revised Manual. The revised Manual contains extensive disclosure requirements. As a result, after a state adopts the revised Manual, its statutory basis of accounting will include informative disclosures appropriate for that basis of accounting. The NAIC Annual Statement Instructions prescribe the financial statements to be included in the annual audited financial report. Some states may not adopt the revised Manual or may adopt it with significant departures. How should auditors evaluate whether informative disclosures in financial statements prepared on a statutory basis are appropriate?[11] [As amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5.]

.61 *Interpretation*—Financial statements prepared on a statutory basis are financial statements prepared on a comprehensive basis of accounting other than GAAP according to section 623, *Special Reports*, paragraph .04). Section 623.09 states that "When reporting on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, the auditor should consider whether the financial statements

[11] It is possible for one of three different situations to occur: The state adopted the revised Manual without significant departures, adopted the revised Manual with significant departures, or has not yet adopted the revised Manual. [Footnote added, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5.]

(including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used. The auditor should apply essentially the same criteria to financial statements prepared on an other comprehensive basis of accounting as those applied to financial statements prepared in conformity with generally accepted accounting principles. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation as discussed in section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, paragraph .04. [Title of section 411 amended, effective for reports issued or reissued on or after June 30, 2001, by Statement on Auditing Standards No. 93. As amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5.]

.62 Section 623.02 states that generally accepted auditing standards apply when an auditor conducts an audit of and reports on financial statements prepared on an other comprehensive basis of accounting. Thus, in accordance with the third standard of reporting, cinformative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.d

.63 *Question*—What types of items or matters should auditors consider in evaluating whether informative disclosures are reasonably adequate?

.64 *Interpretation*—Section 623.09 and .10 indicates that financial statements prepared on a comprehensive basis of accounting other than GAAP should include all informative disclosures that are appropriate for the basis of accounting used. That includes a summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from GAAP. Section 623.10 also states that when cthe financial statements [prepared on an other comprehensive basis of accounting] contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate.d [As amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5.]

[.65–.66] [Paragraphs deleted by the issuance of Statement of Position 01-5, December 2001.]

.67 *Question*—How does the auditor evaluate whether csimilar informative disclosuresd are appropriate for—

a. Items and transactions that are accounted for essentially the same or in a similar manner under a statutory basis as under GAAP?

b. Items and transactions that are accounted for differently under a statutory basis than under GAAP?

c. Items and transactions that are accounted for differently under requirements of the state of domicile than under the revised Manual?

[As amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5.]

.68 *Interpretation*—Disclosures in statutory basis financial statements for items and transactions that are accounted for essentially the same or in a similar manner under the statutory basis as under GAAP should be the same as, or similar to, the disclosures required by GAAP unless the revised Manual specifically states the NAIC Codification rejected the GAAP disclosures. Disclosures should also include those required by the revised Manual. [As amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5.]

[.69] [Paragraph deleted by the issuance of Statement of Position 01-5, December 2001.]

.70 Disclosures in statutory basis financial statements for items or transactions that are accounted for differently under the statutory basis than under GAAP, but in accordance with the revised Manual, should be the disclosures required by the revised Manual. [As amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5.]

.71 If the accounting required by the state of domicile for an item or transaction differs from the accounting set forth in the revised Manual for that item or transaction, but it is in accordance with GAAP or superseded GAAP, the disclosures in statutory basis financial statements for that item or transaction should be the applicable GAAP disclosures for the GAAP or superseded GAAP. If the accounting required by the state of domicile for an item or transaction differs from the accounting set forth in the revised Manual, GAAP or superseded GAAP, sufficient relevant disclosures should be made. [As amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5.]

[.72–.76] [Paragraphs deleted by the issuance of Statement of Position 01-5, December 2001.]

.77 When evaluating the adequacy of disclosures, the auditor should also consider disclosures related to matters that are not specifically identified on the face of the financial statements, such as (*a*) related party transactions, (*b*) restrictions on assets and owners' equity, (*c*) subsequent events, and (*d*) uncertainties. Other matters should be disclosed if such disclosures are necessary to keep the financial statements from being misleading.

[.78–.79] [Paragraphs deleted to reflect conforming changes necessary due to the issuance of FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, and FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*.]

.80 *Question*—There may also be instances in which state requirements have not been revised to reflect a new GAAP disclosure requirement. What are the disclosure requirements in those situations? [Paragraph added, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5.]

.81 *Interpretation*—Until state requirements are determined, the statutory basis financial statements should include disclosures required by new GAAP requirements that are relevant and significant to the statutory basis of accounting, pending acceptance or rejection for inclusion in the revised Manual. [Paragraph added, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5.]

[Issue Date: December, 1991; Revised: February, 1997; Amended: December, 2001.]

13. Reporting on a Special-Purpose Financial Statement That Results in an Incomplete Presentation But Is Otherwise in Conformity With Generally Accepted Accounting Principles

.82 *Question*—An auditor may be requested to report on a special-purpose financial statement that results in an incomplete presentation but otherwise is in conformity with generally accepted accounting principles. For example, an entity wishing to sell a division or product line may prepare an offering memorandum that includes a special-purpose financial statement that presents certain assets and liabilities, revenues and expenses relating to the division or product line being sold. Section 623, *Special Reports*, paragraph .22 states that the auditor may report on a special-purpose financial statement prepared to comply with a contractual agreement. Does an offering memorandum (not including a filing with a regulatory agency) constitute a contractual agreement for purposes of issuing an auditor's report under this section? [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.83 *Interpretation*—No. An offering memorandum generally is a document providing information as the basis for negotiating an offer to sell certain assets or businesses or to raise funds. Normally, parties to an agreement or other specified parties for whom the special-purpose financial presentation is intended have not been identified. Accordingly, the auditor should follow the reporting guidance in section 508, *Reports on Audited Financial Statements*, paragraphs .35–.44 and .58–.60. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.84 *Question*—Does an agreement between a client and one or more third parties other than the auditor to prepare financial statements using a special-purpose presentation constitute a contractual agreement for purposes of issuing an auditor's report under this section? [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.85 *Interpretation*—Yes. In such cases, the auditor should follow the guidance in section 623.22–.26, and use of the auditor's report should be restricted to those within the entity, to the parties to the contract or agreement or to those with whom the entity is negotiating directly.

.86 If there is no such agreement, the auditor should follow the guidance in section 508.35–.44 and .58–.60. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

[.87–.89] [Paragraphs deleted to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 87. Paragraphs renumbered by the issuance of Statement of Position 01-5, December 2001.]

[Issue Date: May, 1995; Revised: February, 1999.]

14. Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting

.90 *Question*—Section 623, *Special Reports*, paragraph .10, requires that financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles (GAAP) include a summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from GAAP. It also states that when such financial statements contain items that are the same as, or similar to, those in statements prepared in conformity with GAAP, "similar informative disclosures are appropriate." To illustrate how to apply that statement, section 623.10 says that the disclosures for depreciation, long-term debt, and owners' equity should be "comparable to" those in financial statements prepared in conformity with GAAP. That paragraph then states that the auditor "should also consider" the need for disclosure of matters that are not specifically identified on the face of the statements, such as (*a*) related party transactions, (*b*) restrictions on assets and owners' equity, (*c*) subsequent events, and (*d*) uncertainties. How should the guidance in section 623.10 be applied in evaluating the adequacy of disclosure in financial statements prepared on the cash, modified cash, or income tax basis of accounting? [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.91 *Interpretation*—The discussion of the basis of presentation may be brief; for example: "The accompanying financial statements present financial results on the accrual basis of accounting used for federal income tax reporting." Only the primary differences from GAAP need to be described. To illustrate, assume that several items are accounted for differently than they would be under GAAP, but that only the differences in depreciation calculations are significant. In that situation, a brief description of the depreciation differences is all that would be necessary, and the remaining differences need not be described. Quantifying differences is not required. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.92 If cash, modified cash, or income tax basis financial statements contain elements, accounts, or items for which GAAP would require disclosure, the statements should either provide the relevant disclosure that would be required for those items in a GAAP presentation or provide information that communicates the substance of that disclosure. That may result in substituting qualitative information for some of the quantitative information required for GAAP presentations. For example, disclosing the repayment terms of significant long-term borrowings may sufficiently communicate information about future principal reduction without providing the summary of principal reduction during each of the next five years that would be required for a GAAP presentation. Similarly, disclosing estimated percentages of revenues, rather than amounts that GAAP presentations would require, may sufficiently convey the significance of sales or leasing to related parties. GAAP disclosure requirements that are not relevant to the measurement of the element, account, or item need not be considered. To illustrate:

a. The fair value information that FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* [AC section I80], would require disclosing for debt and equity securities reported in GAAP presentations would not be relevant when the basis of presentation does not adjust the cost of such securities to their fair value.

b. The information based on actuarial calculations that FASB Statement No. 87, *Employers' Accounting for Pensions* [AC section P16], would require disclosing for contributions to defined benefit plans reported in GAAP presentations would not be relevant in income tax or cash basis financial statements.

[Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.93 If GAAP sets forth requirements that apply to the presentation of financial statements, then cash, modified cash, and income tax basis statements should either comply with those requirements or provide information that communicates the substance of those requirements. The substance of GAAP presentation requirements may be communicated using qualitative information and without modifying the financial statement format. For example:

a. Information about the effects of accounting changes, discontinued operations, and extraordinary items could be disclosed in a note to the financial statements without following the GAAP presentation requirements in the statement of results of operations, using those terms, or disclosing net-of-tax effects.

b. Instead of showing expenses by their functional classifications, the income tax basis statement of activities of a trade organization could present expenses according to their natural classifications, and a note to the statement could use estimated percentages to communicate information about expenses incurred by the major program and supporting services. A voluntary health and welfare organization could take such an approach instead of presenting the matrix of natural and functional expense classifications that would be required for a GAAP presentation, or, if information has been gathered for the Form 990 matrix required for such organizations, it could be presented either in the form of a separate statement or in a note to the financial statements.

c. Instead of showing the amounts of, and changes in, the unrestricted and temporarily and permanently restricted classes of net assets, which would be required for a GAAP presentation, the income tax basis statement of financial position of a voluntary health and welfare organization could report total net assets or fund balances, the related statement of activities could report changes in those totals, and a note to the financial statements could provide information, using estimated or actual amounts or percentages, about the restrictions on those amounts and on any deferred restricted amounts, describe the major restrictions, and provide information about significant changes in restricted amounts.

[Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.94 Presentations using the cash basis of accounting, the modified cash basis, or the cash basis used for income tax reporting often include a presentation consisting entirely or mainly of cash receipts and disbursements. Such presentations need not conform with the requirements for a statement of cash flows that would be included in a GAAP presentation. While a statement of cash flows is not required in presentations using the cash, modified cash, or income tax basis of accounting, if a presentation of cash receipts and disbursements is presented in a format similar to a statement of cash flows or if the entity chooses to present such a statement, for example in a presentation on

the accrual basis of accounting used for federal income tax reporting, the statement should either conform to the requirements for a GAAP presentation or communicate their substance. As an example, the statement of cash flows might disclose noncash acquisitions through captions on its face. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.95 If GAAP would require disclosure of other matters, the auditor should consider the need for that same disclosure or disclosure that communicates the substance of those requirements. Some examples are contingent liabilities, going concern considerations, and significant risks and uncertainties. However, the disclosures need not include information that is not relevant to the basis of accounting. To illustrate, the general information about the use of estimates that is required to be disclosed in GAAP presentations by Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, would not be relevant in a presentation that has no estimates, such as one based on cash receipts and disbursements. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

[Issue Date: January, 1998.]

AU Section 625

Reports on the Application of Accounting Principles

Source: SAS No. 50; SAS No. 97.

Issue date, unless otherwise indicated: July, 1986.

Introduction

.01 There may be differing interpretations as to whether and, if so, how existing accounting principles apply to new transactions and financial products.[1] Management and others often consult with accountants on the application of accounting principles to those transactions and products, or to increase their knowledge of specific financial reporting issues.[2] Such consultations often provide relevant information and insights not otherwise available. [As amended, effective for written reports issued or oral advice provided on or after June 30, 2002, by Statement on Auditing Standards No. 97.]

.02 For purposes of this section, reporting accountant refers to an accountant in public practice[3] who prepares a written report[4] or provides oral advice on the application of accounting principles to specified transactions involving facts and circumstances of a specific entity, or the type of opinion that may be rendered on a specific entity's financial statements. Continuing accountant refers to an accountant who has been engaged to report on the financial statements of a specific entity.[5] [Paragraph added, effective for written reports issued or oral advice provided on or after June 30, 2002, by Statement on Auditing Standards No. 97.]

.03 This section provides guidance that a reporting accountant, either in connection with a proposal to obtain a new client or otherwise, should apply when preparing a written report on—

a. The application of accounting principles to specified transactions, either completed or proposed, involving facts and circumstances of a specific entity ("specific transactions").

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[1] Accounting principles include generally accepted accounting principles and other comprehensive bases of accounting. See section 623, *Special Reports*, paragraph .04 for a description of other comprehensive bases of accounting.

[2] [Footnote deleted by the issuance of Statement on Auditing Standards No. 97, June 2002.]

[3] See ET section 92.25 of the AICPA Code of Professional Conduct for a definition of "practice of public accounting."

[4] Written report, for purposes of this section, includes any written communication that expresses a conclusion on the appropriate accounting principle(s) to be applied or the type of opinion that may be rendered on an entity's financial statements. [Footnote added, effective for written reports issued or oral advice provided on or after June 30, 2002, by Statement on Auditing Standards No. 97.]

[5] An accountant engaged by the entity to perform services other than reporting on the entity's financial statements is not considered to be a continuing accountant. [Footnote added, effective for written reports issued or oral advice provided on or after June 30, 2002, by Statement on Auditing Standards No. 97.]

b. The type of opinion that may be rendered on a specific entity's financial statements.

This section also applies to oral advice that the reporting accountant concludes is intended to be used by a principal to the transaction as an important factor considered in reaching a decision on the application of accounting principles to a specific transaction, or the type of opinion that may be rendered on a specific entity's financial statements. [Paragraph renumbered and amended, effective for written reports issued or oral advice provided on or after June 30, 2002, by Statement on Auditing Standards No. 97.]

.04 Because of the nature of a transaction not involving facts or circumstances of a specific entity (chypothetical transactiond), a reporting accountant cannot know, for example, whether the continuing accountant has reached a different conclusion on the application of accounting principles for the same or a similar transaction, or how the specific entity has accounted for similar transactions in the past. Therefore an accountant should not undertake an engagement to provide a written report on the application of accounting principles to a hypothetical transaction. [Paragraph added, effective for written reports issued or oral advice provided on or after June 30, 2002, by Statement on Auditing Standards No. 97.]

.05 This section does not apply to a continuing accountant with respect to the specific entity whose financial statements he or she has been engaged to report on, to engagements either to assist in litigation involving accounting matters or to provide expert testimony in connection with such litigation, or to professional advice provided to another accountant in public practice. [Paragraph renumbered and amended, effective for written reports issued or oral advice provided on or after June 30, 2002, by Statement on Auditing Standards No. 97.]

.06 This section also does not apply to communications such as position papers prepared by an accountant for the purpose of presenting views on an issue involving the application of accounting principles or the type of opinion that may be rendered. Position papers include newsletters, articles, speeches and texts thereof, lectures and other forms of public presentations, and letters for the public record to professional and governmental standard-setting bodies. However, if communications of the type discussed in this paragraph are intended to provide guidance on the application of accounting principles to a specific transaction, or on the type of opinion that may be rendered on a specific entity's financial statements, the provisions of this section should be followed. [Paragraph renumbered and amended, effective for written reports issued or oral advice provided on or after June 30, 2002, by Statement on Auditing Standards No. 97.]

Performance Standards

.07 The reporting accountant should exercise due professional care in performing the engagement and should have adequate technical training and proficiency. The reporting accountant should also plan the engagement adequately, supervise the work of assistants, if any, and accumulate sufficient information to provide a reasonable basis for the professional judgment described in the report. The reporting accountant should consider the circumstances under which the written report or oral advice is requested, the purpose of the request, and the intended use of the written report or oral advice. [Paragraph renumbered and amended, effective for written reports issued or oral advice provided on or after June 30, 2002, by Statement on Auditing Standards No. 97.]

.08 To aid in forming a judgment, the reporting accountant should perform the following procedures: (*a*) obtain an understanding of the form and substance of the transaction(s); (*b*) review applicable generally accepted accounting principles (see section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles); (*c*) if appropriate, consult with other professionals or experts; and (*d*) if appropriate, perform research or other procedures to ascertain and consider the existence of creditable precedents or analogies. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 97, June 2002.]

.09 When evaluating accounting principles that relate to a specific transaction or determining the type of opinion that may be rendered on a specific entity's financial statements, the reporting accountant should consult with the continuing accountant of the entity to ascertain all the available facts relevant to forming a professional judgment. The continuing accountant may provide information not otherwise available to the reporting accountant regarding, for example, the following: the form and substance of the transaction; how management has applied accounting principles to similar transactions; whether the method of accounting recommended by the continuing accountant is disputed by management; or whether the continuing accountant has reached a different conclusion on the application of accounting principles or the type of opinion that may be rendered on the entity's financial statements. The reporting accountant should explain to the entity's management the need to consult with the continuing accountant, request permission to do so, and request the entity's management to authorize the continuing accountant to respond fully to the reporting accountant's inquiries. The responsibilities of an entity's continuing accountant to respond to inquiries by the reporting accountant are the same as the responsibilities of a predecessor auditor to respond to inquiries by a successor auditor. See section 315, *Communications Between Predecessor and Successor Auditors*, paragraph .10. [Paragraph renumbered and amended, effective for written reports issued or oral advice provided on or after June 30, 2002, by Statement on Auditing Standards No. 97.]

Reporting Standards

.10 The accountant's written report should be addressed to the requesting entity (for example, management or the board of directors of the entity), and should ordinarily include the following:[6]

a. A brief description of the nature of the engagement and a statement that the engagement was performed in accordance with applicable AICPA standards.

b. Identification of the specific entity, a description of the transaction(s), a statement of the relevant facts, circumstances, and assumptions, and a statement about the source of the information.

c. A statement describing the appropriate accounting principle(s) (including the country of origin) to be applied or type of opinion that may be rendered on the entity's financial statements, and, if appropriate, a description of the reasons for the reporting accountant's conclusion.

[6] Although the reporting standards in this section apply only to written reports, accountants may find this guidance useful in providing oral advice. [Footnote renumbered and amended, effective for written reports issued or oral advice provided on or after June 30, 2002, by Statement on Auditing Standards No. 97.]

d. A statement that the responsibility for the proper accounting treatment rests with the preparers of the financial statements, who should consult with their continuing accountant.

e. A statement that any difference in the facts, circumstances, or assumptions presented may change the report.

f. A separate paragraph at the end of the report that includes the following elements:[7]

- A statement indicating that the report is intended solely for the information and use of the specified parties;
- An identification of the specified parties to whom use is restricted; and
- A statement that the report is not intended to be and should not be used by anyone other than the specified parties.

[Paragraph renumbered and amended, effective for written reports issued or oral advice provided on or after June 30, 2002, by Statement on Auditing Standards No. 97.]

.11 The following is an illustration of sections of the report described in paragraph .10.

Introduction

We have been engaged to report on the appropriate application of accounting principles generally accepted in [*country of origin of such principles*] to the specific transaction described below. This report is being issued to ABC Company for assistance in evaluating accounting principles for the described specific transaction. Our engagement has been conducted in accordance with standards established by the American Institute of Certified Public Accountants.

Description of Transaction

The facts, circumstances, and assumptions relevant to the specific transaction as provided to us by the management of ABC Company are as follows:

Appropriate Accounting Principles

[*Text discussing generally accepted accounting principles*]

Concluding Comments

The ultimate responsibility for the decision on the appropriate application of accounting principles generally accepted in [*country of origin of such principles*] for an actual transaction rests with the preparers of financial statements, who should consult with their continuing accountant. Our judgment on the appropriate application of accounting principles generally accepted in [*country of origin of such principles*] for the described specific transaction is based solely on the facts provided to us as described above; should these facts and circumstances differ, our conclusion may change.

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[7] See section 532, *Restricting the Use of an Auditor's Report*. Although restricted, this is not intended to preclude distribution of the report to the continuing accountant. [Footnote added, effective for written reports issued or oral advice provided on or after June 30, 2002, by Statement on Auditing Standards No. 97.]

Restricted Use

This report is intended solely for the information and use of the board of directors and management of ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

[Paragraph renumbered and amended, effective for written reports issued or oral advice provided on or after June 30, 2002, by Statement on Auditing Standards No. 97.]

AU Section 634

Letters for Underwriters and Certain Other Requesting Parties

(Supersedes SAS No. 49)

Source: SAS No. 72; SAS No. 76; SAS No. 86.

See section 9634 for interpretations of this section.

Effective for comfort letters issued on or after June 30, 1993, unless otherwise indicated.

Introduction

.01 This section[1] provides guidance to accountants for performing and reporting on the results of engagements to issue letters for underwriters and certain other requesting parties described in and meeting the requirements of paragraph .03, .04, or .05 (commonly referred to as "comfort letters") in connection with financial statements and financial statement schedules contained in registration statements filed with the Securities and Exchange Commission (SEC) under the Securities Act of 1933 (the Act) and other securities offerings. In paragraph .09, this section also provides guidance to accountants for performing and reporting on the results of engagements to issue letters for certain requesting parties, other than underwriters or other parties with a due diligence defense under section 11 of the Act, that are described in, but do not meet the requirements of, paragraph .03, .04, or .05. [As amended, effective for letters issued pursuant to paragraph .09 of this section after April 30, 1996, by Statement on Auditing Standards No. 76.]

.02 The service of accountants providing letters for underwriters developed following enactment of the Act. Section 11 of the Act provides that underwriters, among others, could be liable if any part of a registration statement contains material omissions or misstatements. The Act also provides for an affirmative defense for underwriters if it can be demonstrated that, after a reasonable investigation, the underwriter has reasonable grounds to believe that there were no material omissions or misstatements. Consequently, underwriters request accountants to assist them in developing a record of reasonable investigation. An accountant issuing a comfort letter is one of a number of procedures that may be used to establish that an underwriter has conducted a reasonable investigation.

Applicability

.03 Accountants may provide a comfort letter to underwriters,[2] or to other parties with a statutory due diligence defense under section 11 of the Act,

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[1] [Footnote deleted by the issuance of Statement on Auditing Standards No. 76, September 1995.]

[2] The term *underwriter* is defined in section 2 of the Act as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any

(continued)

in connection with financial statements and financial statement schedules included (incorporated by reference) in registration statements filed with the SEC under the Act. A comfort letter may be addressed to parties with a statutory due diligence defense under section 11 of the Act, other than a named underwriter, only when a law firm or attorney for the requesting party issues a written opinion to the accountants that states that such party has a due diligence defense under section 11 of the Act.[3] An attorney's letter indicating that a party "may" be deemed to be an underwriter or has liability substantially equivalent to that of an underwriter under the securities laws would not meet this requirement. If the requesting party, in a securities offering registered pursuant to the Act, other than a named underwriter (such as a selling shareholder or sales agent) cannot provide such a letter, he or she must provide the representation letter described in paragraphs .06 and .07 for the accountants to provide them with a comfort letter.

.04 Accountants may also issue a comfort letter to a broker-dealer or other financial intermediary, acting as principal or agent in an offering or a placement of securities, in connection with the following types of securities offerings:

- Foreign offerings, including Regulation S, Eurodollar, and other offshore offerings
- Transactions that are exempt from the registration requirements of section 5 of the Act, including those pursuant to Regulation A, Regulation D, and Rule 144A
- Offerings of securities issued or backed by governmental, municipal, banking, tax-exempt, or other entities that are exempt from registration under the Act

In these situations the accountants may provide a comfort letter to a broker-dealer or other financial intermediary in connection with a securities offering only if the broker-dealer or other financial intermediary provides in writing the representations described in paragraphs .06 and .07.

.05 Accountants may also issue a comfort letter in connection with acquisition transactions (for example, cross-comfort letters in a typical Form S-4 or merger proxy situation) in which there is an exchange of stock and such comfort letters are requested by the buyer or seller, or both, as long as the representation letter described in paragraphs .06 and .07 is provided. An accountants' report on a preliminary investigation in connection with a proposed transaction (for example, a merger, an acquisition, or a financing) is not covered by this section; accountants should refer to the guidance in AT section 201, *Agreed-Upon Procedures Engagements*. [Revised, January 2001, to reflect

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(footnote continued)

security, or participates or has a participation in the direct or indirect participation in any such undertaking or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph, the term *issuer* shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer."

[3] This section is not intended to preclude accountants from providing to the client's board of directors, when appropriate, a letter addressed to the board of directors similar in content to a comfort letter. See the auditing interpretation "Letters to Directors Relating to Annual Reports on Form 10-K" (section 9634.01-.09).

conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

.06 The required elements of the representation letter from a broker-dealer or other financial intermediary, or of other requesting parties described in paragraphs .03 and .05, are as follows:

- The letter should be addressed to the accountants.
- The letter should contain the following:

  "This review process, applied to the information relating to the issuer, is (will be) substantially consistent[4] with the due diligence review process that we would perform if this placement of securities (or issuance of securities in an acquisition transaction) were being registered pursuant to the Securities Act of 1933 (the Act). We are knowledgeable with respect to the due diligence review process that would be performed if this placement of securities were being registered pursuant to the Act."[5]

- The letter should be signed by the requesting party.

.07 An example of a letter, setting forth the required elements specified in paragraph .06, from a party requesting a comfort letter follows:

[*Date*]

Dear ABC Accountants:

[*Name of financial intermediary*], as principal or agent, in the placement of [*identify securities*] to be issued by [*name of issuer*], will be reviewing certain information relating to [*issuer*] that will be included (incorporated by reference) in the document [*if appropriate, the document should be identified*], which may be delivered to investors and utilized by them as a basis for their investment decision. This review process, applied to the information relating to the issuer, is (will be) substantially consistent with the due diligence review process that we would perform if this placement of securities[6] were being registered pursuant to the Securities Act of 1933 (the Act). We are knowledgeable with respect to the due diligence review process that would be performed if this placement of securities were being registered pursuant to the Act. We hereby request that you deliver to us a "comfort" letter concerning the financial statements of the issuer and certain statistical and other data included in the offering document. We will contact you to identify the procedures we wish you to follow and the form we wish the comfort letter to take.

Very truly yours,

[*Name of Financial Intermediary*]

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[4] It is recognized that what is "substantially consistent" may vary from situation to situation and may not be the same as that done in a registered offering of the same securities for the same issuer; whether the procedures being, or to be, followed will be "substantially consistent" will be determined by the requesting party on a case-by-case basis.

[5] If a nonunderwriter requests a comfort letter in connection with a securities offering pursuant to the Act, the wording of the representation letter should be revised as follows:

"This review process . . . is substantially consistent with the due diligence review process that an underwriter would perform in connection with this placement of securities. We are knowledgeable with respect to the due diligence review process that an underwriter would perform in connection with a placement of securities registered pursuant to the Securities Act of 1933."

[6] In an acquisition of securities, this sentence could be reworded to refer to "issuance of securities." See paragraph .05.

.08 When one of the parties identified in paragraphs .03, .04, and .05 requests a comfort letter and has provided the accountants with the representation letter described above, the accountants should refer in the comfort letter to the requesting party's representations (see example P [paragraph .64]).

.09 When one of the parties identified in paragraphs .03, .04, or .05, other than an underwriter or other party with a due diligence defense under section 11 of the Act, requests a comfort letter but does not provide the representation letter described in paragraphs .06 and .07, accountants should not provide a comfort letter but may provide another form of letter. In such a letter, the accountants should not provide negative assurance on the financial statements as a whole, or on any of the specified elements, accounts, or items thereof. The other guidance in this section is applicable to performing procedures in connection with a letter and on the form of the letter (see paragraphs .36 through .43 and .54 through .60). Example Q in the Appendix [paragraph .64] provides an example of a letter issued in such a situation. Any such letter should include the following statements:

a. It should be understood that we have no responsibility for establishing (and did not establish) the scope and nature of the procedures enumerated in the paragraphs above; rather, the procedures enumerated therein are those the requesting party asked us to perform. Accordingly, we make no representations regarding questions of legal interpretation[7] or regarding the sufficiency for your purposes of the procedures enumerated in the preceding paragraphs; also, such procedures would not necessarily reveal any material misstatement of the amounts or percentages listed above as set forth in the offering circular. Further, we have addressed ourselves solely to the foregoing data and make no representations regarding the adequacy of disclosures or whether any material facts have been omitted. This letter relates only to the financial statement items specified above and does not extend to any financial statement of the company taken as a whole.

b. The foregoing procedures do not constitute an audit conducted in accordance with generally accepted auditing standards. Had we performed additional procedures or had we conducted an audit or a review of the company's [*give dates of any interim financial statements*] consolidated financial statements in accordance with standards established by the American Institute of Certified Public Accountants, other matters might have come to our attention that would have been reported to you.

c. These procedures should not be taken to supplant any additional inquiries or procedures that you would undertake in your consideration of the proposed offering.

d. This letter is solely for your information and to assist you in your inquiries in connection with the offering of the securities covered

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[7] If this letter is requested in connection with a secured debt offering, the accountants should also refer to the attest interpretation "Responding to Requests for Reports on Matters Relating to Solvency" (AT section 9101.23–.33) for inclusion of additional statements. [Footnote added, effective for letters issued pursuant to paragraph .09 of this section after April 30, 1996, by Statement on Auditing Standards No. 76. Footnote revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

by the offering circular, and it is not to be used, circulated, quoted, or otherwise referred to for any other purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the offering document or any other document, except that reference may be made to it in any list of closing documents pertaining to the offering of the securities covered by the offering document.

e. We have no responsibility to update this letter for events and circumstances occurring after [*cutoff date*].

[As amended, effective for letters issued pursuant to this paragraph after April 30, 1996, by Statement on Auditing Standards No. 76.]

.10 When a party other than those described in paragraphs .03, .04, or .05 requests a comfort letter, the accountants should not provide that party with a comfort letter or the letter described in paragraph .09 or example Q [paragraph .64]. The accountants may instead provide that party with a report on agreed-upon procedures and should refer to AT section 201, *Agreed-Upon Procedures Engagements*, for guidance. [Paragraph added, effective for letters issued pursuant to paragraph .09 of this section after April 30, 1996, by Statement on Auditing Standards No. 76. Revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

General

.11 The services of independent accountants include audits of financial statements and financial statement schedules included (incorporated by reference) in registration statements filed with the SEC under the Act. In connection with this type of service, accountants are often called upon to confer with clients, underwriters, and their respective counsel concerning the accounting and auditing requirements of the Act and the SEC and to perform other services. One of these other services is the issuance of letters for underwriters, which generally address the subjects described in paragraph .22. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.12 Much of the uncertainty, and consequent risk of misunderstanding, with regard to the nature and scope of comfort letters has arisen from a lack of recognition of the necessarily limited nature of the comments that accountants can properly make with respect to financial information, in a registration statement or other offering document (hereafter referred to as a registration statement), that has not been audited in accordance with generally accepted auditing standards and, accordingly, is not covered by their opinion. In requesting comfort letters, underwriters are generally seeking assistance on matters of importance to them. They wish to perform a "reasonable investigation" of financial and accounting data not "expertized"[8] (that is, covered by a report of independent accountants, who consent to be named as experts, based on an audit performed in accordance with generally accepted auditing standards)

[8] See the auditing interpretation "Consenting to Be Named as an Expert in an Offering Document in Connection With Securities Offerings Other Than Those Registered Under the Securities Act of 1933" (section 9711.12-.15). [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

as a defense against possible claims under section 11 of the Act.[9] What constitutes a reasonable investigation of unaudited financial information sufficient to satisfy an underwriter's purposes has never been authoritatively established. Consequently, only the underwriter can determine what is sufficient for his or her purposes. Accountants will normally be willing to assist the underwriter, but the assistance accountants can provide by way of comfort letters is subject to limitations. One limitation is that independent accountants can properly comment in their professional capacity only on matters to which their professional expertise is substantially relevant. Another limitation is that procedures short of an audit, such as those contemplated in a comfort letter, provide the accountants with a basis for expressing, at the most, negative assurance.[10] Such limited procedures may bring to the accountants' attention significant matters affecting the financial information, but they do not provide assurance that the accountants will become aware of any or all significant matters that would be disclosed in an audit. Accordingly, there is necessarily a risk that the accountants may have provided negative assurance of the absence of conditions or matters that may prove to have existed. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.13 This section deals with several different kinds of matters. First, it addresses whether, in a number of areas involving professional standards, it is proper for independent accountants, acting in their professional capacity, to comment in a comfort letter on specified matters, and, if so, the form such a comment should take. Second, practical suggestions are offered on which form of comfort letter is suitable in a given circumstance, procedural matters, the dating of letters, and what steps may be taken when information that may require special mention in a letter comes to the accountants' attention.[11] Third, it suggests ways of reducing or avoiding the uncertainties, described in the preceding paragraph, regarding the nature and extent of accountants' responsibilities in connection with a comfort letter. Accountants who have been requested to follow a course other than what has been recommended, with regard to points not involving professional standards, would do well to consult their legal counsel. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.14 Comfort letters are not required under the Act, and copies are not filed with the SEC. It is nonetheless a common condition of an underwriting agreement in connection with the offering for sale of securities registered with the SEC under the Act that the accountants are to furnish a comfort letter. Some underwriters do not make the receipt of a comfort letter a condition of the

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[9] See section 711, *Filings Under Federal Securities Statutes*, for a discussion of certain responsibilities of accountants that result from the inclusion of their reports in registration statements. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

[10] Negative assurance consists of a statement by accountants that, as a result of performing specified procedures, nothing came to their attention that caused them to believe that specified matters do not meet a specified standard (for example, that nothing came to their attention that caused them to believe that any material modifications should be made to the unaudited financial statements or unaudited condensed financial statements for them to be in conformity with generally accepted accounting principles). [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

[11] It is important to note that although the illustrations in this section describe procedures that may be followed by accountants as a basis for their comments in comfort letters, this section does not necessarily prescribe such procedures. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

underwriting agreement or purchase agreement (hereafter referred to as the underwriting agreement) but nevertheless ask for such a letter.[12] [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.15 The accountants should suggest to the underwriter that they meet together with the client to discuss the procedures to be followed in connection with a comfort letter; during this meeting, the accountants may describe procedures that are frequently followed (see the examples in the appendix [paragraph .64]). Because of the accountants' knowledge of the client, such a meeting may substantially assist the underwriter in reaching a decision about procedures to be followed by the accountants. However, any discussion of procedures should be accompanied by a clear statement that the accountants cannot furnish any assurance regarding the sufficiency of the procedures for the underwriter's purposes, and the appropriate way of expressing this is shown in paragraph 4 of example A [paragraph .64]. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.16 Because the underwriter will expect the accountants to furnish a comfort letter of a scope to be specified in the underwriting agreement, a draft of that agreement should be furnished to the accountants so that they can indicate whether they will be able to furnish a letter in acceptable form. It is desirable practice for the accountants, promptly after they have received the draft of the agreement (or have been informed that a letter covering specified matters, although not a condition of the agreement, will nonetheless be requested), to prepare a draft of the form of the letter they expect to furnish. To the extent possible, the draft should deal with all matters to be covered in the final letter and should use exactly the same terms as those to be used in the final letter (subject, of course, to the understanding that the comments in the final letter cannot be determined until the procedures underlying it have been performed). The draft letter should be identified as a draft to avoid giving the impression that the procedures described therein have been performed. This practice of furnishing a draft letter at an early point permits the accountants to make clear to the client and the underwriter what they may expect the accountants to furnish. Thus furnished with a draft letter, the underwriter is afforded the opportunity to discuss further with the accountants the procedures that the accountants have indicated they expect to follow and to request any additional procedures that the underwriter may desire. If the additional procedures pertain to matters relevant to the accountants' professional competence, the accountants would ordinarily be willing to perform them, and it is desirable for them to furnish the underwriter with an appropriately revised draft letter. The accountants may reasonably assume that the underwriter, by indicating his or her acceptance of the draft comfort letter, and subsequently, by accepting the letter in final form, considers the procedures described sufficient for his or her purposes. It is important,

[12] Except when the context otherwise requires, the word underwriter (or certain other requesting parties, as described in paragraphs .03, .04, and .05), as used in this section refers to the managing, or lead, underwriter, who typically negotiates the underwriting agreement for a group of underwriters whose exact composition is not determined until shortly before a registration statement becomes effective. In competitive bidding situations in which legal counsel for the underwriters acts as the underwriters' representative prior to opening and acceptance of the bid, the accountants should carry out the discussions and other communications contemplated by this section with the legal counsel until the underwriter is selected. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

therefore, that the procedures[13] to be followed by the accountants be clearly set out in the comfort letter, in both draft and final form, so that there will be no misunderstanding about the basis on which the accountants' comments have been made and so that the underwriter can decide whether the procedures performed are sufficient for his or her purposes. For reasons explained in paragraph .12, statements or implications that the accountants are carrying out such procedures as they consider necessary should be avoided, since this may lead to misunderstanding about the responsibility for the sufficiency of the procedures for the underwriter's purposes. The following is a suggested form of legend that may be placed on the draft letter for identification and explanation of its purposes and limitations.

> This draft is furnished solely for the purpose of indicating the form of letter that we would expect to be able to furnish [*name of underwriter*] in response to their request, the matters expected to be covered in the letter, and the nature of the procedures that we would expect to carry out with respect to such matters. Based on our discussions with [*name of underwriter*], it is our understanding that the procedures outlined in this draft letter are those they wish us to follow.[14] Unless [*name of underwriter*] informs us otherwise, we shall assume that there are no additional procedures they wish us to follow. The text of the letter itself will depend, of course, on the results of the procedures, which we would not expect to complete until shortly before the letter is given and in no event before the cutoff date indicated therein.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.17 Comfort letters are occasionally requested from more than one accountant (for example, in connection with registration statements to be used in the subsequent sale of shares issued in recently effected mergers and from predecessor auditors). At the earliest practicable date, the client should advise any other accountants who may be involved about any letter that may be required from them and should arrange for them to receive a draft of the underwriting agreement so that they may make arrangements at an early date for the preparation of a draft of their letter (a copy of which should be furnished to the principal accountants) and for the performance of their procedures. In addition, the underwriter may wish to meet with the other accountants for the purposes discussed in paragraph .15. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.18 There may be situations in which more than one accountant is involved in the audit of the financial statements of a business and in which the reports of more than one accountant appear in the registration statement. For example, certain significant divisions, branches, or subsidiaries may be audited by other accountants. The principal accountants (that is, those who

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[13] When the accountants have been requested to provide negative assurance on interim financial information or capsule financial information and the procedures required for an SAS No. 100 [section 722] review have been performed, those procedures need not be specified. See paragraphs .37 through .41. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. Footnote revised, January 2003, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 100.]

[14] In the absence of any discussions with the underwriter, the accountants should outline in the draft letter those procedures specified in the underwriting agreement that they are willing to perform. In that event, the sentence to which this footnote refers should be revised as follows: "In the absence of any discussions with [*name of underwriter*], we have set out in this draft letter those procedures referred to in the draft underwriting agreement (of which we have been furnished a copy) that we are willing to follow." [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

report on the consolidated financial statements and, consequently, are asked to give a comfort letter with regard to information expressed on a consolidated basis) should read the letters of the other accountants reporting on significant units. Such letters should contain statements similar to those contained in the comfort letter prepared by the principal accountants, including statements about their independence. The principal accountants should state in their comfort letters that (*a*) reading letters of the other accountants was one of the procedures followed, and (*b*) the procedures performed by the principal accountants (other than reading the letters of the other accountants) relate solely to companies audited by the principal accountants and to the consolidated financial statements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.19 Regulations under the Act permit companies, in certain circumstances, to register a designated amount of securities for continuous or delayed offerings during an extended period by filing one "shelf" registration statement. At the effective date of a shelf registration statement, the registrant may not have selected an underwriter (see footnote 12). A client or the legal counsel designated to represent the underwriting group might, however, ask the accountants to issue a comfort letter at the effective date of a shelf registration statement to expedite the due diligence activities of the underwriter when he or she is subsequently designated and to avoid later corrections of financial information included in an effective prospectus. However, as stated in paragraph .12, only the underwriter can determine the procedures that will be sufficient for his or her purposes. Under these circumstances, therefore, the accountants should not agree to furnish a comfort letter addressed to the client, legal counsel or a nonspecific addressee such as "any or all underwriters to be selected." The accountants may agree to furnish the client or legal counsel for the underwriting group with a draft comfort letter describing the procedures that the accountants have performed and the comments the accountants are willing to express as a result of those procedures. The draft comfort letter should include a legend, such as the following, describing the letter's purpose and limitations:

> This draft describes the procedures that we have performed and represents a letter we would be prepared to sign as of the effective date of the registration statement if the managing underwriter had been chosen at that date and requested such a letter. Based on our discussions with [*name of client or legal counsel*], the procedures set forth are similar to those that experience indicates underwriters often request in such circumstances. The text of the final letter will depend, of course, on whether the managing underwriter who is selected requests that other procedures be performed to meet his or her needs and whether the managing underwriter requests that any of the procedures be updated to the date of issuance of the signed letter.

A signed comfort letter may be issued to the underwriter selected for the portion of the issue then being offered when the underwriting agreement for an offering is signed and on each closing date. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.20 Accountants, when issuing a letter under the guidance provided in this section, may not issue any additional letters or reports, under any other section, to the underwriter or the other requesting parties identified in paragraphs .03, .04, and .05 (hereinafter referred to as the underwriter) in connection with the offering or placement of securities, in which the accountants comment on items for which commenting is otherwise precluded by this section. [Paragraph renumbered by the issuance of Statement on Auditing

Standards No. 76, September 1995. As amended, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86.]

.21 While the guidance in this section generally addresses comfort letters issued in connection with securities offerings registered pursuant to the Act, it also provides guidance on comfort letters issued in other securities transactions. However, the guidance that specifically refers to compliance of the information commented on with SEC rules and regulations, such as compliance with Regulation S-X[15] or S-K,[16] generally applies only to comfort letters issued in connection with securities offerings registered pursuant to the Act. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

Guidance on the Format and Contents of Comfort Letters

.22 This section (paragraphs .22 through .62) provides guidance on the format and possible contents of a typical comfort letter. It addresses how the comfort letter should be dated, to whom it may be addressed, and the contents of the introductory paragraph of the comfort letter. Further, it addresses the subjects that may be covered in a comfort letter:

a. The independence of the accountants (paragraphs .31 and .32)

b. Whether the audited financial statements and financial statement schedules included (incorporated by reference) in the registration statement comply as to form in all material respects with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC (paragraphs .33 and .34)

c. Unaudited financial statements, condensed interim financial information, capsule financial information, pro forma financial information, financial forecasts, management's discussion and analysis (MD&A), and changes in selected financial statement items during a period subsequent to the date and period of the latest financial statements included (incorporated by reference) in the registration statement (paragraphs .29 and .35 through .53)

d. Tables, statistics, and other financial information included (incorporated by reference) in the registration statement (paragraphs .54 through .62)

e. Negative assurance as to whether certain non-financial statement information, included (incorporated by reference) in the registration statement complies as to form in all material respects with Regulation S-K (paragraph .57)

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. As amended, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86.]

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[15] Regulation S-X, "Form and Content of and Requirements for Financial Statements, Securities Act of 1933, Securities Exchange Act of 1934, Public Utility Holding Company Act of 1935, Investment Company Act of 1940, and Energy Policy and Conservation Act of 1975." [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

[16] Regulation S-K, "Standard Instructions for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975." [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

Dating

.23 The letter ordinarily is dated on or shortly before the effective date (that is, the date on which the registration statement becomes effective). On rare occasions, letters have been requested to be dated at or shortly before the filing date (that is, the date on which the registration statement is first filed with the SEC). The underwriting agreement ordinarily specifies the date, often referred to as the "cutoff date," to which certain procedures described in the letter are to relate (for example, a date five days before the date of the letter). The letter should state that the inquiries and other procedures described in the letter did not cover the period from the cutoff date to the date of the letter. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.24 An additional letter may also be dated at or shortly before the closing date (that is, the date on which the issuer or selling security holder delivers the securities to the underwriter in exchange for the proceeds of the offering). If more than one letter is requested, it will be necessary to carry out the specified procedures and inquiries as of the cutoff date for each letter. Although comments contained in an earlier letter may, on occasion, be incorporated by reference in a subsequent letter (see example C [paragraph .64]), any subsequent letter should relate only to information in the registration statement as most recently amended. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

Addressee

.25 The letter should not be addressed or given to any parties other than the client and the named underwriters,[17] broker-dealer, financial intermediary or buyer or seller. The appropriate addressee is the intermediary who has negotiated the agreement with the client, and with whom the accountants will deal in discussions regarding the scope and sufficiency of the letter. When a comfort letter is furnished to other accountants, it should be addressed in accordance with the guidance in this paragraph and copies should be furnished to the principal accountants and their client. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

Introductory Paragraph

.26 It is desirable to include an introductory paragraph similar to the following:

> We have audited the [*identify the financial statements and financial statement schedules*] included (incorporated by reference) in the registration statement (no. 33-00000) on Form _____filed by the company under the Securities Act of 1933 (the Act); our reports with respect thereto are also included (incorporated by reference) in that registration statement. The registration statement, as amended as of _____, is herein referred to as the registration statement.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

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[17] An example of an appropriate form of address for this purpose is "The Blank Company and XYZ & Company, as Representative of the Several Underwriters." [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.27 When the report on the audited financial statements and financial statement schedules included (incorporated by reference) in the registration statement departs from the standard report, for instance, where one or more explanatory paragraphs or a paragraph to emphasize a matter regarding the financial statements have been added to the report, the accountants should refer[18] to that fact in the comfort letter and discuss the subject matter of the paragraph.[19] In those rare instances in which the SEC accepts a qualified opinion on historical financial statements, the accountants should refer to the qualification in the opening paragraph of the comfort letter and discuss the subject matter of the qualification. (See also paragraph .35*f*.) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.28 The underwriter occasionally requests the accountants to repeat in the comfort letter their report on the audited financial statements included (incorporated by reference) in the registration statement. Because of the special significance of the date of the accountants' report, the accountants should not repeat their opinion.[20] The underwriter sometimes requests negative assurance regarding the accountants' report. Because accountants have a statutory responsibility with respect to their opinion as of the effective date of a registration statement, and because the additional significance, if any, of negative assurance is unclear and such assurance may therefore give rise to misunderstanding, accountants should not give such negative assurance. Furthermore, the accountants should not give negative assurance with respect to financial statements and financial statement schedules that have been audited and are reported on in the registration statement by other accountants. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.29 The accountants may refer in the introductory paragraphs of the comfort letter to the fact that they have issued reports on—[21]

a. Condensed financial statements that are derived from audited financial statements (see section 552, *Reporting on Condensed Financial Statements and Selected Financial Data*).

b. Selected financial data (see section 552).

c. Interim financial information (see section 722).

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[18] The accountants may also refer in the opening paragraph to expansions of their report that do not affect their opinion on the basic financial statements, for example, expansions of their report regarding (*a*) interim financial information accompanying or included in the notes to audited financial statements (see section 722.50) or (*b*) required supplementary information described in section 558, *Required Supplementary Information*, paragraphs .08 through .11. See paragraph .30 of this section. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. Footnote revised, September 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 98. Footnote revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 100.]

[19] The accountants need not refer to or discuss explanatory paragraphs covering consistency of application of accounting principles. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

[20] See section 530, *Dating of the Independent Auditor's Report*, paragraphs .03 through .08. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

[21] Except for a review report on management's discussion and analysis (MD&A), the accountants should not refer to or attach to the comfort letter any restricted use report, such as a report on agreed-upon procedures. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. As amended, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86.]

d. Pro forma financial information (see AT section 401, *Reporting on Pro Forma Financial Information*).

e. A financial forecast (see AT section 301, *Financial Forecasts and Projections*).

f. Management's discussion and analysis (see AT section 701, *Management's Discussion and Analysis*).

Such a reference should be to the accountants' reports that were previously issued, and if the reports are not included (incorporated by reference) in the registration statement, they may be attached to the comfort letter.[22] In referring to previously issued reports, the accountants should not repeat their reports in the comfort letter or otherwise imply that they are reporting as of the date of the comfort letter or that they assume responsibility for the sufficiency of the procedures for the underwriter's purposes. However, for certain information on which they have reported, the accountants may agree to comment regarding compliance with rules and regulations adopted by the SEC (see paragraphs .33 and .34). Accountants should not mention in a comfort letter reports issued in accordance with section 325, *Communications About Control Deficiencies in An Audit of Financial Statements*, or any restricted use reports issued to a client in connection with procedures performed on the client's internal control in accordance with AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. As amended, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86. Revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

.30 An underwriter may also request that the accountants comment in their comfort letter on (*a*) unaudited interim financial information required by item 302(a) of Regulation S-K, to which section 722 pertains or (*b*) required supplementary information, to which section 558, *Required Supplementary Information*, pertains. Section 722 and section 558 provide that the accountants should expand the standard report on the audited financial statements to refer to such information when the scope of their procedures with regard to the information was restricted or when the information appears not to be presented in conformity with generally accepted accounting principles or, for required supplementary information, applicable guidelines. Such expansions of the accountants' standard report in the registration statement would ordinarily be referred to in the opening paragraph of the comfort letter (see also paragraph .35*f*). Additional comments on such unaudited information are therefore unnecessary. However, if the underwriter requests that the accountants perform procedures with regard to such information in addition to those performed in connection with their review or audit as prescribed by sections 722 and 558, the accountants may do so and report their findings. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

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[22] When the accountant does not perform a review or an examination of MD&A or does not attach or refer to a report on MD&A, the accountant may perform agreed-upon procedures with respect to items in MD&A, subject to controls over financial reporting (see paragraph .55). [Footnote added, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86.]

Independence

.31 It is customary in conjunction with SEC filings for the underwriting agreement to provide for the accountants to make a statement in the letter concerning their independence. This may be done substantially as follows:

> We are independent certified public accountants with respect to The Blank Company, Inc., within the meaning of the Act and the applicable rules and regulations thereunder adopted by the SEC.

Regulation S-K requires disclosure in the prospectus and registration statement of interests of named experts (including independent accountants) in the registrant. Regulation S-X precludes accountants who report on financial statements included (incorporated by reference) in a registration statement from having interests of the type requiring disclosure in the prospectus or registration statement. Therefore, if the accountants make a statement in a comfort letter that they are independent within the meaning of the Act and the applicable rules and regulations thereunder adopted by the SEC, any additional comments on independence would be unnecessary.[22a] In a non-SEC filing, the accountants may refer to the AICPA's *Code of Professional Conduct* [ET section 101]. This may be done substantially as follows:

> We are independent certified public accountants with respect to The Blank Company, Inc., under rule 101 of the AICPA's *Code of Professional Conduct* and its interpretations and rulings.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.32 When comfort letters are requested from more than one accountant (see paragraphs .17 and .18), each accountant must, of course, be sure he or she is independent within the meaning of the Act and the applicable rules and regulations thereunder adopted by the SEC. The accountants for previously nonaffiliated companies recently acquired by the registrant would not be required to have been independent with respect to the company whose shares are being registered. In such a case, the accountants should modify the wording suggested in paragraph .31 and make a statement regarding their independence along the following lines.

> As of [*insert date of the accountants' most recent report on the financial statements of their client*] and during the period covered by the financial statements on which we reported, we were independent certified public accountants with respect to [*insert the name of their client*] within the meaning of the Act and the applicable rules and regulations thereunder adopted by the SEC.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

[22a] The SEC, in Financial Reporting Release No. 50 dated February 18, 1998, recognized the establishment of the Independence Standards Board (ISB) and indicated that the SEC intends to look to the ISB as the private sector body responsible for establishing independence standards and interpretations for auditors of public entities. [Footnote added, June 1999, to acknowledge the SEC's recognition of the ISB.]

Compliance With SEC Requirements

.33 The accountants may be requested to express an opinion on whether the financial statements covered by their report comply as to form with the pertinent accounting requirements adopted by the SEC.[23] This may be done substantially as follows:

> In our opinion [*include phrase "except as disclosed in the registration statement," if applicable*], the [*identify the financial statements and financial statement schedules*] audited by us and included (incorporated by reference) in the registration statement comply as to form in all material respects with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC.[24]

If there is a material departure from the pertinent rules and regulations adopted by the SEC, the departure should be disclosed in the letter.[25] An appropriate manner of doing this is shown in example K [paragraph .64]. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.34 Accountants may provide positive assurance on compliance as to form with requirements under the rules and regulations adopted by the SEC only with respect to those rules and regulations applicable to the form and content of financial statements and financial statement schedules that they have audited. Accountants are limited to providing negative assurance on compliance as to form when the financial statements or financial statement schedules have not been audited. (For guidance in commenting on compliance as to form, see paragraph .37 regarding unaudited condensed interim financial information, paragraph .42 regarding pro forma financial information, paragraph .44

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[23] The phrase rules and regulations adopted by the SEC is used because accountants should not be expected to be familiar with, or express assurances on compliance with, informal positions of the SEC staff. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. Footnote subsequently renumbered and amended, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86.]

[24] Certain financial statements may be incorporated in a registration statement under the Act by reference to filings under the Securities Exchange Act of 1934 (the 1934 Act). In those circumstances, the accountants may refer to whether the audited financial statements and financial statement schedules included (incorporated by reference) in the registration statement comply as to form in all material respects with the applicable accounting requirements of the 1934 Act and the related rules and regulations adopted by the SEC (see Example B [paragraph .64]). However, the accountants should not refer to compliance with the provisions of the 1934 Act regarding internal accounting control. See AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*, paragraph .82. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. Footnote subsequently renumbered and amended, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86. Footnote revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

[25] Departures from rules and regulations adopted by the SEC that require mention in a comfort letter ordinarily do not affect fair presentation in conformity with generally accepted accounting principles; however, if they do, the accountants will, of course, mention these departures in expressing their opinion and in consenting to the use of their report in the registration statement. If departures from rules and regulations adopted by the SEC that require mention in a comfort letter either are not disclosed in the registration statement or have not been agreed to by representatives of the SEC, the accountants should carefully consider whether a consent to the use of their report in the registration statement should be issued. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. Footnote subsequently renumbered and amended, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86.]

regarding a forecast, and paragraph .57 regarding Regulation S-K items.[26]) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

Commenting in a Comfort Letter on Information Other Than Audited Financial Statements

General

.35 Comments included in the letter will often concern (*a*) unaudited condensed interim financial information (see paragraphs .36 through .38),[27] (*b*) capsule financial information (see paragraphs .36 and .39 through .41), (*c*) pro forma financial information (see paragraphs .42 and .43), (*d*) financial forecasts (see paragraphs .36 and .44), and (*e*) changes in capital stock, increases in long-term debt, and decreases in other specified financial statement items (see paragraphs .36 and .45 through .53). For commenting on these matters, the following guidance is important:

a. As explained in paragraph .16, the agreed-upon procedures performed by the accountants should be set forth in the letter, except that when the accountants have been requested to provide negative assurance on interim financial information or capsule financial information, the procedures involved in an SAS No. 71 [section 722] review need not be specified (see paragraphs .37 through .41 of this section and paragraph 4 of example A [paragraph .64]).

b. To avoid any misunderstanding about the responsibility for the sufficiency of the agreed-upon procedures for the underwriter's purposes, the accountants should not make any statements, or imply that they have applied procedures that they have determined to be necessary or sufficient for the underwriter's purposes. If the accountants state that they have performed an SAS No. 71 [section 722] review, this does not imply that those procedures are sufficient for the underwriter's purposes. The underwriter may ask the accountants to perform additional procedures. For example, if the underwriter requests the accountants to apply additional procedures and specifies items of financial information to be reviewed and the materiality level for changes in those items that would necessitate further inquiry by the accountants, the accountants may perform those procedures and should describe them in their letter. Descriptions of procedures in the comfort letter should include descriptions of the criteria specified by the underwriter.

c. Terms of uncertain meaning (such as *general review*, *limited review*, *reconcile*, *check*, or *test*) should not be used in describing the

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[26] Accountants should not comment in a comfort letter on compliance as to form of MD&A with rules and regulations adopted by the SEC; accountants may agree to examine or review MD&A in accordance with AT section 701. [Footnote added, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86. Footnote revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

[27] The SEC requirements specify condensed financial statements. However, the guidance in paragraphs .37 and .38 also applies to complete financial statements. For purposes of this section, interim financial statements may be for a twelve-month period ending on a date other than the entity's normal year end. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 86, March 1998.]

work, unless the procedures comprehended by these terms are described in the comfort letter.

d. The procedures performed with respect to interim periods may not disclose changes in capital stock, increases in long-term debt or decreases in the specified financial statement items, inconsistencies in the application of generally accepted accounting principles, instances of noncompliance as to form with accounting requirements of the SEC, or other matters about which negative assurance is requested. An appropriate manner of making this clear is shown in the last three sentences in paragraph 4 of example A [paragraph .64].

e. Matters to be covered by the letter should be made clear in the meetings with the underwriter and should be identified in the underwriting agreement and in the draft comfort letter. Since there is no way of anticipating other matters that would be of interest to an underwriter, accountants should not make a general statement in a comfort letter that, as a result of carrying out the specified procedures, nothing else has come to their attention that would be of interest to the underwriter.

f. When the report on the audited financial statements and financial statement schedules in the registration statement departs from the auditor's standard report, and the comfort letter includes negative assurance with respect to subsequent unaudited condensed interim financial information included (incorporated by reference) in the registration statement or with respect to an absence of specified subsequent changes, increases, or decreases, the accountant should consider the effect thereon of the subject matter of the qualification, explanatory paragraph(s), or paragraph(s) emphasizing a matter regarding the financial statements. The accountant should also follow the guidance in paragraph .27. An illustration of how this type of situation may be dealt with is shown in example I [paragraph .64].

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

Knowledge of Internal Control

.36 The accountants should not comment in a comfort letter on (*a*) unaudited condensed interim financial information, (*b*) capsule financial information, (*c*) a financial forecast when historical financial statements provide a basis for one or more significant assumptions for the forecast, or (*d*) changes in capital stock, increases in long-term debt and decreases in selected financial statement items, unless they have obtained knowledge of a client's internal control as it relates to the preparation of both annual and interim financial information. Knowledge of the client's internal control over financial reporting includes knowledge of the control environment, risk assessment, control activities, information and communication, and monitoring. Sufficient knowledge of a client's internal control as it relates to the preparation of annual financial information ordinarily would have been acquired, and may have been acquired with respect to interim financial information, by the accountants who have audited a client's financial statements for one or more periods. When the accountants have not audited the most recent annual financial statements, and thus have not acquired sufficient knowledge of the entity's internal control, the accountants should perform procedures to obtain that knowledge. [Paragraph renumbered by the issuance of Statement on Auditing Standards

No. 76, September 1995. Revised, February 1997, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 78.]

Unaudited Condensed Interim Financial Information

.37 Comments concerning the unaudited condensed interim financial information[28] included (incorporated by reference) in the registration statement provide negative assurance as to whether (*a*) any material modifications should be made to the unaudited condensed interim financial information for it to be in conformity with generally accepted accounting principles and (*b*) the unaudited condensed interim financial information complies as to form in all material respects with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC. Accountants may comment in the form of negative assurance only when they have conducted a review of the interim financial information in accordance with section 722. The accountants may (*a*) state in the comfort letter that they have performed the procedures identified in section 722 for a review of interim financial information (see paragraphs 4a and 5a of example A [paragraph .64] or (*b*) if the accountants have issued a report on the review, they may mention that fact in the comfort letter. If it is mentioned in the comfort letter, the accountants should attach the review report to the letter unless the review report is already included (incorporated by reference) in the registration statement. When the accountants have not conducted a review in accordance with section 722, the accountants may not comment in the form of negative assurance and are, therefore, limited to reporting procedures performed and findings obtained (see example O [paragraph .64]). [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.38 The letter should specifically identify any unaudited condensed interim financial information and should state that the accountants have not audited the condensed interim financial information in accordance with generally accepted auditing standards and do not express an opinion concerning such information. An appropriate manner of making this clear is shown in paragraph 3 of example A [paragraph .64]. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

Capsule Financial Information

.39 In some registration statements, the information shown in the audited financial statements or unaudited condensed interim financial information is supplemented by unaudited summarized interim information for subsequent periods (commonly called "capsule financial information"). This capsule financial information (either in narrative or tabular form) often is provided for the most recent interim period and for the corresponding period of the prior year. With regard to selected capsule financial information, the accountants—

a. May give negative assurance with regard to conformity with generally accepted accounting principles and may refer to whether the dollar amounts were determined on a basis substantially

[28] When accountants are engaged to perform procedures on interim financial information, they may have additional responsibilities under certain circumstances. The accountants should refer to section 722 for guidance. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 86, March 1998.]

consistent with that of the corresponding amounts in the audited financial statements if (1) the selected capsule financial information is presented in accordance with the minimum disclosure requirements of Accounting Principles Board (APB) Opinion No. 28, paragraph 30 [AC section I73.146], and (2) the accountants have performed an SAS No. 71 [section 722] review of the financial statements underlying the capsule financial information. If those conditions have not been met, the accountants are limited to reporting procedures performed and findings obtained.

b. May give negative assurance as to whether the dollar amounts were determined on a basis substantially consistent with that of the corresponding amounts in the audited financial statements if the selected capsule financial information is more limited than the minimum disclosures described in APB Opinion 28, paragraph 30 (see example L [paragraph .64]), as long as the accountants have performed an SAS No. 71 [section 722] review of the financial statements underlying the capsule financial information. If an SAS No. 71 [section 722] review has not been performed, the accountants are limited to reporting procedures performed and findings obtained.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.40 The underwriter occasionally asks the accountants to give negative assurance with respect to the unaudited interim financial statements or unaudited condensed interim financial information (see paragraph .37 and the interim financial information requirements of Regulation S-X) that underlie the capsule financial information and asks the accountants to state that the capsule financial information agrees with amounts set forth in such statements. Paragraphs 4*b* and 5*b* in example L [paragraph .64] provide an example of the accountants' comments in these circumstances. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.41 The underwriter might ask the accountants to give negative assurance on the unaudited condensed interim financial information, or information extracted therefrom, for a monthly period ending after the latest financial statements included (incorporated by reference) in the registration statement. In those cases, the guidance in paragraph .37 is applicable. The unaudited condensed interim financial information should be attached to the comfort letter so that it is clear what financial information is being referred to; if the client requests, the unaudited condensed interim financial information may be attached only to the copy of the letter intended for the managing underwriter. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

Pro Forma Financial Information

.42 Accountants should not comment in a comfort letter on pro forma financial information unless they have an appropriate level of knowledge of the accounting and financial reporting practices of the entity (or, in the case of a business combination, of a significant constituent part of the combined entity). This would ordinarily have been obtained by the accountants auditing or reviewing historical financial statements of the entity for the most recent annual or interim period for which the pro forma financial information is presented. Accountants should not give negative assurance in a comfort letter on the application of pro forma adjustments to historical amounts, the compilation

of pro forma financial information, whether the pro forma financial information complies as to form in all material respects with the applicable accounting requirements of rule 11-02 of Regulation S-X or otherwise provide negative assurance with respect to pro forma financial information unless they have obtained the required knowledge described above and they have performed an audit of the annual financial statements, or an SAS No. 71 [section 722] review of the interim financial statements, of the entity (or, in the case of a business combination, of a significant constituent part of the combined entity) to which the pro forma adjustments were applied. In the case of a business combination, the historical financial statements of each constituent part of the combined entity on which the pro forma financial information is based should be audited or reviewed. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.43 If the accountants have obtained the required knowledge as described in paragraph .36, but have not met the requirements for giving negative assurance, the accountants are limited to reporting procedures performed and findings obtained. (See example O [paragraph .64].) The accountants should comply with the relevant guidance on reporting the results of agreed-upon procedures in AT section 201. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. Revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

Financial Forecasts

.44 For accountants to perform agreed-upon procedures on a financial forecast and comment thereon in a comfort letter, they should obtain the knowledge described in paragraph .36 and then perform procedures prescribed in AT section 301.69, for reporting on compilation of a forecast. Having performed these procedures, they should follow the guidance in AT section 301.18 and .19 regarding reports on compilations of prospective financial information and should attach their report[29] thereon to the comfort letter.[30] Then they can perform additional procedures and report their findings in the comfort letter (see examples E and O [paragraph .64]). Accountants may not provide negative assurance on the results of procedures performed. Further, accountants may not provide negative assurance with respect to compliance of the forecast with rule 11-03 of Regulation S-X unless they have performed an examination of the forecast in accordance with AT section 301. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.

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[29] For purposes of issuing a comfort letter, if the forecast is included in the registration statement, the forecast must be accompanied by an indication that the accountants have not examined the forecast and therefore do not express an opinion on it. If a compilation report on the forecast has been issued in connection with the comfort letter, the report need not be included in the registration statement. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 86, March 1998.]

[30] When a client's securities are subject to regulation by the SEC, the accountants should be aware of the SEC's views regarding independence when agreeing to perform a compilation of a forecast. Independence may be deemed to be impaired when services include preparation or assembly of financial forecasts. The SEC generally will not question the accountants' independence, however, when services are limited to issuing a report on a forecast as a result of performing the procedures stated in paragraph 5 of AT section 301.69. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 86, March 1998. Footnote revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

Revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

Subsequent Changes

.45 Comments regarding subsequent changes typically relate to whether there has been any change in capital stock, increase in long-term debt or decreases in other specified financial statement items during a period, known as the "change period," subsequent to the date and period of the latest financial statements included (incorporated by reference) in the registration statement (see paragraph .50). These comments would also address such matters as subsequent changes in the amounts of (*a*) net current assets or stockholders' equity and (*b*) net sales and the total and per-share amounts of income before extraordinary items and of net income. The accountants ordinarily will be requested to read minutes and make inquiries of company officials relating to the whole of the change period.[31] For the period between the date of the latest financial statements made available and the cutoff date, the accountants must base their comments solely on the limited procedures actually performed with respect to that period (which, in most cases, will be limited to the reading of minutes and the inquiries of company officials referred to in the preceding sentence), and their comfort letter should make this clear (see paragraph 6 of example A [paragraph .64]). [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.46 If the underwriter requests negative assurance as to subsequent changes in specified financial statement items as of a date less than 135 days from the end of the most recent period for which the accountants have performed an audit or a review, the accountants may provide such negative assurance in the comfort letter. For instance—

- When the accountants have audited the December 31, 19X6, financial statements, the accountants may provide negative assurance on increases and decreases of specified financial statement items as of any date up to May 14 (135 days subsequent to December 31).

- When the accountants have audited the December 31, 19X6, financial statements and have also conducted an SAS No. 71 [section 722] review of the interim financial information as of and for the quarter ended March 31, 19X7, the accountants may provide negative assurance as to increases and decreases of specified financial statement items as of any date up to August 14, 19X7 (135 days subsequent to March 31).

An appropriate manner of expressing negative assurance regarding subsequent changes is shown in paragraphs 5b and 6 of example A [paragraph .64], if there has been no decrease and in example M [paragraph .64], if there has been a decrease. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.47 However, if the underwriter requests negative assurance as to subsequent changes in specified financial statement items as of a date 135 days or

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[31] The answers to these inquiries generally should be supported by appropriate written representations of the company officials. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 86, March 1998.]

more subsequent to the end of the most recent period for which the accountants have performed an audit or a review, the accountants may not provide negative assurance but are limited to reporting procedures performed and findings obtained (see example O [paragraph .64]). [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.48 In order that comments on subsequent changes be unambiguous and their determination be within accountants' professional expertise, the comments should not relate to "adverse changes," since that term has not acquired any clearly understood meaning. If there has been a change in an accounting principle during the change period, the accountants should note that fact in the letter. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.49 Comments on the occurrence of changes in capital stock, increases in long-term debt, and decreases in other specified financial statement items are limited to changes, increases, or decreases not disclosed in the registration statement. Accordingly, the phrase "except for changes, increases, or decreases that the registration statement discloses have occurred or may occur" should be included in the letter when it has come to the accountants' attention that a change, increase, or decrease has occurred during the change period, and the amount of such change, increase, or decrease is disclosed in the registration statement. This phrase need not be included in the letter when no changes, increases, or decreases in the specified financial statement items are disclosed in the registration statement. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.50 ***Change period.*** In the context of a comfort letter, a decrease occurs when the amount of a financial statement item at the cutoff date or for the change period (as if financial statements had been prepared at that date and for that period) is less than the amount of the same item at a specified earlier date or for a specified earlier period. With respect to the items mentioned in paragraph .45, the term *decrease* means (*a*) any combination of changes in amounts of current assets and current liabilities that results in decreased net current assets, (*b*) any combination of changes in amounts of assets and liabilities that results in decreased stockholders' equity, (*c*) decreased net sales, and (*d*) any combination of changes in amounts of sales, expenses and outstanding shares that results in decreased total and per-share amounts of income before extraordinary items and of net income (including, in each instance, a greater loss or other negative amount). The change period for which the accountants give negative assurance in the comfort letter ends on the cutoff date (see paragraph .23) and ordinarily begins, for balance sheet items, immediately after the date of the latest balance sheet in the registration statement and, for income statement items, immediately after the latest period for which such items are presented in the registration statement. The comparison relates to the entire period and not to portions of that period. A decrease during one part of the period may be offset by an equal or larger increase in another part of the period; however, because there was no decrease for the period as a whole, the comfort letter would not report the decrease occurring during one part of the period (see, however, paragraph .62). [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.51 The underwriting agreement usually specifies the dates as of which, and periods for which, data at the cutoff date and data for the change period are to be compared. For balance sheet items, the comparison date is normally that

of the latest balance sheet included (incorporated by reference) in the registration statement (that is, immediately prior to the beginning of the change period). For income statement items, the comparison period or periods might be one or more of the following: (*a*) the corresponding period of the preceding year, (*b*) a period of corresponding length immediately preceding the change period, (*c*) a proportionate part of the preceding fiscal year, or (*d*) any other period of corresponding length chosen by the underwriter. Whether or not specified in the underwriting agreement, the date and period used in comparison should be identified in the comfort letter in both draft and final form so that there is no misunderstanding about the matters being compared and so that the underwriter can determine whether the comparison period is suitable for his or her purposes. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.52 The underwriter occasionally requests that the change period begin immediately after the date of the latest audited balance sheet (which is, ordinarily, also the closing date of the latest audited statement of income) in the registration statement, even though the registration statement includes a more recent unaudited condensed balance sheet and condensed statement of income. The use of the earlier date may defeat the underwriter's purpose, since it is possible that an increase in one of the items referred to in paragraph .45 occurring between the dates of the latest audited and unaudited balance sheets included (incorporated by reference) in the registration statement might more than offset a decrease occurring after the latter date. A similar situation might arise in the comparison of income statement items. In these circumstances, the decrease occurring after the date of the latest unaudited condensed interim financial statements included (incorporated by reference) in the registration statement would not be reported in the comfort letter. It is desirable for the accountants to explain the foregoing considerations to the underwriter; however, if the underwriter nonetheless requests the use of a change period or periods other than those described in paragraph .50, the accountants may use the period or periods requested. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.53 When other accountants are involved and their letters do not disclose matters that affect the negative assurance given, an appropriate manner of expressing these comments is shown in example J [paragraph .64]. When appropriate, the principal accountants may comment that there were no decreases in the consolidated financial statement items despite the possibility that decreases have been mentioned by the other accountants. In such a case, the principal accountants could make a statement that "nothing came to our attention regarding the consolidated financial statements as a result of the specified procedures (which, so far as the related company was concerned, consisted solely of reading the other accountants' letter) that caused us to believe that...." [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

Tables, Statistics, and Other Financial Information

.54 The underwriting agreement sometimes calls for a comfort letter that includes comments on tables, statistics, and other financial information appearing in the registration statement. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.55 The accountants should refrain from commenting on certain matters in a comfort letter. Except as indicated in the next sentence, they should comment only with respect to information (*a*) that is expressed in dollars (or

percentages derived from such dollar amounts) and that has been obtained from accounting records that are subject to the entity's controls over financial reporting or (*b*) that has been derived directly from such accounting records by analysis or computation. The accountants may also comment on quantitative information that has been obtained from an accounting record if the information is subject to the same controls over financial reporting as the dollar amounts. The accountants should not comment on matters merely because they happen to be present and are capable of reading, counting, measuring, or performing other functions that might be applicable. Examples of matters that, unless subjected to the entity's controls over financial reporting (which is not ordinarily the case), should not be commented on by the accountants include the square footage of facilities, number of employees (except as related to a given payroll period), and backlog information.[32] The accountants should not comment on tables, statistics, and other financial information relating to an unaudited period unless (*a*) they have performed an audit of the client's financial statements for a period including or immediately prior to the unaudited period or have completed an audit for a later period or (*b*) they have otherwise obtained knowledge of the client's internal control as provided for in paragraph .36 herein. In addition, the accountants should not comment on information subject to legal interpretation, such as beneficial share ownership. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. As amended, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86.]

.56 As with comments relating to financial statement information, it is important that the procedures followed by the accountants with respect to other information be clearly set out in the comfort letter, in both draft and final form, so that there will be no misunderstanding about the basis of the comments on the information. Further, so that there will be no implication that the accountants are furnishing any assurance with respect to the sufficiency of the procedures for the underwriter's intended purpose, the comfort letter should contain a statement to this effect. An appropriate way of expressing this is shown in paragraph 10 of example F [paragraph .64] (see also paragraph .16 of this section). [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.57 Certain financial information in registration statements is included because of specific requirements of Regulation S-K. Accountants may comment as to whether this information is in conformity with the disclosure requirements of Regulation S-K if the following conditions are met:

a. The information is derived from the accounting records subject to the entity's controls over financial reporting, or has been derived directly from such accounting records by analysis or computation.

b. This information is capable of evaluation against reasonable criteria that have been established by the SEC.

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[32] Accountants generally will be unable to comment on nonfinancial data presented in MD&A. However, when the accountants have conducted an examination or a review of MD&A in accordance with AT section 701, they may agree to trace nonfinancial data presented outside MD&A to similar data included in the MD&A presentation. When the accountant does not perform a review or an examination of MD&A or does not attach or refer to a report on MD&A, the accountant may perform agreed-upon procedures with respect to items in MD&A subject to controls over financial reporting. [Footnote added, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86. Footnote revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

The following are the disclosure requirements of Regulation S-K[33] that generally meet these conditions:

- Item 301, "Selected Financial Data"
- Item 302, "Supplementary Financial Information"
- Item 402, "Executive Compensation"
- Item 503(d), "Ratio of Earnings to Fixed Charges"

Accountants may not give positive assurance on conformity with the disclosure requirements of Regulation S-K; they are limited to giving negative assurance, since this information is not given in the form of financial statements and generally has not been audited by the accountants. Even with respect to the abovementioned items, there may be situations in which it would be inappropriate to provide negative assurance with respect to conformity of this information with Regulation S-K because conditions (*a*) and (*b*) above have not been met. Since information relevant to Regulation S-K disclosure requirements other than those noted previously is generally not derived from the accounting records subject to the entity's controls over financial reporting, it is not appropriate for the accountants to comment on conformity of this information with Regulation S-K. The accountants' inability to comment on conformity with Regulation S-K does not preclude accountants from performing procedures and reporting findings with respect to this information. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.58 To avoid ambiguity, the specific information commented on in the letter should be identified by reference to specific captions, tables, page numbers, paragraphs, or sentences. Descriptions of the procedures followed and the findings obtained may be stated individually for each item of specific information commented on. Alternatively, if the procedures and findings are adequately described, some or all of the descriptions may be grouped or summarized, as long as the applicability of the descriptions to items in the registration statement is clear and the descriptions do not imply that the accountants assume responsibility for the adequacy of the procedures. It would also be appropriate to present a matrix listing the financial information and common procedures employed and indicating the procedures applied to the specific items. Another presentation that could be used identifies procedures performed with specified symbols and identifies items to which those procedures have been applied directly on a copy of the prospectus which is attached to the comfort letter. (See examples F, G, and H [paragraph .64]). [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.59 Comments in the comfort letter concerning tables, statistics, and other financial information included (incorporated by reference) in the registration statement should be made in the form of a description of the procedures followed; the findings (ordinarily expressed in terms of agreement between items compared); and in some cases, as described below, statements with respect to the acceptability of methods of allocation used in deriving the figures

[33] Accountants should not comment in a comfort letter on compliance as to form of MD&A with rules and regulations adopted by the SEC; accountants may agree to examine or review MD&A in accordance with AT section 701. [Footnote added, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86. Footnote revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

commented on. Whether comments on the allocation of income or expense items between categories of sales (such as military and commercial sales) may appropriately be made will depend on the extent to which such allocation is made in, or can be derived directly by analysis or computation from, the client's accounting records. In any event, such comments, if made, should make clear that such allocations are to a substantial extent arbitrary, that the method of allocation used is not the only acceptable one, and that other acceptable methods of allocation might produce significantly different results. Furthermore, no comments should be made regarding segment information (or the appropriateness of allocations made to derive segment information) included in financial statements, since the accountants' report encompasses that information (see section 435, *Segment Information*).[34] Appropriate ways of expressing comments on tables, statistics, and other financial information are shown in examples F, G, and H [paragraph .64]. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

.60 In comments concerning tables, statistics, and other financial information, the expression "presents fairly" (or a variation of it) should not be used. That expression, when used by independent accountants, ordinarily relates to presentations of financial statements and should not be used in commenting on other types of information. Except with respect to requirements for financial statements and certain Regulation S-K items discussed in paragraph .57, the question of what constitutes appropriate information for compliance with the requirements of a particular item of the registration statement form is a matter of legal interpretation outside the competence of accountants. Consequently, the letter should state that the accountants make no representations regarding any matter of legal interpretation. Since the accountants will not be in a position to make any representations about the completeness or adequacy of disclosure or about the adequacy of the procedures followed, the letter should so state. It should point out, as well, that such procedures would not necessarily disclose material misstatements or omissions in the information to which the comments relate. An appropriate manner of expressing the comments is shown in examples F, G, and H [paragraph .64]. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

Concluding Paragraph

.61 In order to avoid misunderstanding of the purpose and intended use of the comfort letter, it is desirable that the letter conclude with a paragraph along the following lines:

> This letter is solely for the information of the addressees and to assist the underwriters[35] in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the registration statement, and it is not to be used, circulated, quoted, or

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[34] See paragraph .30 regarding requests by an underwriter for comments on interim financial information required by item 302(*a*) of Regulation S-K and required supplementary information described in section 558. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 86, March 1998.]

[35] When the letter is furnished by the accountants for a subsidiary and they are not also accountants for the parent company, the letter should include the following phrase at this point: "and for the use of the accountants for [*name of issuer*] in furnishing their letter to the underwriters." [Footnote renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 86, March 1998.]

> otherwise referred to within or without the underwriting group for any other purpose, including, but not limited to, the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the registration statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the registration statement.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

Disclosure of Subsequently Discovered Matters

.62 Accountants who discover matters that may require mention in the final comfort letter but that are not mentioned in the draft letter that has been furnished to the underwriter, such as changes, increases, or decreases in specified items not disclosed in the registration statement (see paragraphs .45 and .49), will naturally want to discuss them with their client so that consideration can be given to whether disclosure should be made in the registration statement. If disclosure is not to be made, the accountants should inform the client that the matters will be mentioned in the comfort letter and should suggest that the underwriter be informed promptly. It is recommended that the accountants be present when the client and the underwriter discuss such matters. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

Effective Date

.63 This section is effective for comfort letters issued on or after June 30, 1993. Early application of this section is encouraged. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

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Appendix

Examples

1. The contents of comfort letters vary, depending on the extent of the information in the registration statement and the wishes of the underwriter or other requesting party. Shelf registration statements may have several closing dates and different underwriters. Descriptions of procedures and findings regarding interim financial statements, tables, statistics, or other financial information that is incorporated by reference from previous 1934 Act filings may have to be repeated in several comfort letters. To avoid restating these descriptions in each comfort letter, accountants may initially issue the comments in a format (such as an appendix) that can be referred to in, and attached to, subsequently issued comfort letters.

Example A: Typical Comfort Letter

2. A typical comfort letter includes—

   a. A statement regarding the independence of the accountants (paragraphs .31 and .32).

   b. An opinion regarding whether the audited financial statements and financial statement schedules included (incorporated by reference) in the registration statement comply as to form in all material respects with the applicable accounting requirements of the Act and related rules and regulations adopted by the SEC (paragraphs .33 and .34).

   c. Negative assurance on whether—

      1. The unaudited condensed interim financial information included (incorporated by reference) in the registration statement (paragraph .37) complies as to form in all material respects with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC.

      2. Any material modifications should be made to the unaudited condensed consolidated financial statements included (incorporated by reference) in the registration statement for them to be in conformity with generally accepted accounting principles.

   d. Negative assurance on whether, during a specified period following the date of the latest financial statements in the registration statement and prospectus, there has been any change in capital stock, increase in long-term debt or any decrease in other specified financial statement items (paragraphs .45 through .53).

Example A is a letter covering all these items. Letters that cover some of the items may be developed by omitting inapplicable portions of example A.

Example A assumes the following circumstances.[1] The prospectus (part I of the registration statement) includes audited consolidated balance sheets as of December 31, 19X5 and 19X4, and audited consolidated statements of income, retained earnings (stockholders' equity), and cash flows for each of the three years in the period ended December 31, 19X5. Part I also includes an unaudited condensed consolidated balance sheet as of March 31, 19X6, and unaudited condensed consolidated statements of income, retained earnings (stockholders' equity), and cash flows for the three-month periods ended March 31, 19X6 and 19X5, reviewed in accordance with section 722 but not previously reported on by the accountants. Part II of the registration statement includes audited consolidated financial statement schedules for the three years ended December 31, 19X5. The cutoff date is June 23, 19X6, and the letter is dated June 28, 19X6. The effective date is June 28, 19X6.

Each of the comments in the letter is in response to a requirement of the underwriting agreement. For purposes of example A, the income statement items of the current interim period are to be compared with those of the corresponding period of the preceding year.

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[1] The example includes financial statements required by SEC regulations to be included in the filing. If additional financial information is covered by the comfort letter, appropriate modifications should be made.

June 28, 19X6

[*Addressee*]

Dear Sirs:

We have audited the consolidated balance sheets of The Blank Company, Inc. (the company) and subsidiaries as of December 31, 19X5 and 19X4, and the consolidated statements of income, retained earnings (stockholders' equity), and cash flows for each of the three years in the period ended December 31, 19X5, and the related financial statement schedules all included in the registration statement (no. 33-00000) on Form S-1 filed by the company under the Securities Act of 1933 (the Act); our reports with respect thereto are also included in that registration statement. The registration statement, as amended on June 28, 19X6, is herein referred to as the registration statement.[2]

In connection with the registration statement—

1. We are independent certified public accountants with respect to the company within the meaning of the Act and the applicable rules and regulations thereunder adopted by the SEC.

2. In our opinion [*include the phrase "except as disclosed in the registration statement," if applicable*], the consolidated financial statements and financial statement schedules audited by us and included in the registration statement comply as to form in all material respects with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC.

3. We have not audited any financial statements of the company as of any date or for any period subsequent to December 31, 19X5; although we have conducted an audit for the year ended December 31, 19X5, the purpose (and therefore the scope) of the audit was to enable us to express our opinion on the consolidated financial statements as of December 31, 19X5, and for the year then ended, but not on the financial statements for any interim period within that year. Therefore, we are unable to and do not express any opinion on the unaudited condensed consolidated balance sheet as of March 31, 19X6, and the unaudited condensed consolidated statements of income, retained earnings (stockholders' equity), and cash flows for the three-month periods ended March 31, 19X6 and 19X5, included in the registration statement, or on the financial position, results of operations, or cash flows as of any date or for any period subsequent to December 31, 19X5.

4. For purposes of this letter we have read the 19X6 minutes of meetings of the stockholders, the board of directors, and [*include other appropriate committees, if any*] of the company and its subsidiaries as set forth in the minute books at June 23, 19X6, officials of the company having advised us that the minutes of all such meetings[3] through that date were set forth therein; we have

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[2] The example assumes that the accountants have not previously reported on the interim financial information. If the accountants have previously reported on the interim financial information, they may refer to that fact in the introductory paragraph of the comfort letter as follows:

Also, we have reviewed the unaudited condensed consolidated financial statements as of March 31, 19X6 and 19X5, and for the three-month periods then ended, as indicated in our report dated May 15, 19X6, which is included (incorporated by reference) in the registration statement. The report may be attached to the comfort letter (see paragraph .29). The accountants may agree to comment in the comment letter on whether the interim financial information complies as to form in all material respects with the applicable accounting requirements of the rules and regulations adopted by the SEC.

[3] The accountants should discuss with the secretary those meetings for which minutes have not been approved. The letter should be modified to identify specifically the unapproved minutes of meetings that the accountants have discussed with the secretary.

carried out other procedures to June 23, 19X6, as follows (our work did not extend to the period from June 24, 19X6, to June 28, 19X6, inclusive):

a. With respect to the three-month periods ended March 31, 19X6 and 19X5, we have—

(i) Performed the procedures specified by the American Institute of Certified Public Accountants for a review of interim financial information as described in SAS No. 71, *Interim Financial Information*, on the unaudited condensed consolidated balance sheet as of March 31, 19X6, and unaudited condensed consolidated statements of income, retained earnings (stockholders' equity), and cash flows for the three-month periods ended March 31, 19X6 and 19X5, included in the registration statement.

(ii) Inquired of certain officials of the company who have responsibility for financial and accounting matters whether the unaudited condensed consolidated financial statements referred to in *a*(i) comply as to form in all material respects with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC.

b. With respect to the period from April 1, 19X6, to May 31, 19X6, we have—

(i) Read the unaudited consolidated financial statements[4] of the company and subsidiaries for April and May of both 19X5 and 19X6 furnished us by the company, officials of the company having advised us that no such financial statements as of any date or for any period subsequent to May 31, 19X6, were available.

(ii) Inquired of certain officials of the company who have responsibility for financial and accounting matters whether the unaudited consolidated financial statements referred to in *b*(i) are stated on a basis substantially consistent with that of the audited consolidated financial statements included in the registration statement.

The foregoing procedures do not constitute an audit conducted in accordance with generally accepted auditing standards. Also, they would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representations regarding the sufficiency of the foregoing procedures for your purposes.

5. Nothing came to our attention as a result of the foregoing procedures, however, that caused us[5] to believe that—

a.

(i) Any material modifications should be made to the unaudited condensed consolidated financial statements described in 4*a*(i), included in the registration

[4] If the interim financial information is incomplete, a sentence similar to the following should be added: "The financial information for April and May is incomplete in that it omits the statements of cash flows and other disclosures."

[5] If there has been a change in accounting principle during the interim period, a reference to that change should be included herein.

statement, for them to be in conformity with generally accepted accounting principles.[6]

(ii) The unaudited condensed consolidated financial statements described in 4*a*(i) do not comply as to form in all material respects with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC.

b.

(i) At May 31, 19X6, there was any change in the capital stock, increase in long-term debt, or decrease in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown in the March 31, 19X6, unaudited condensed consolidated balance sheet included in the registration statement, or

(ii) for the period from April 1, 19X6, to May 31, 19X6, there were any decreases, as compared to the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income, except in all instances for changes, increases, or decreases that the registration statement discloses have occurred or may occur.

6. As mentioned in 4*b*, company officials have advised us that no consolidated financial statements as of any date or for any period subsequent to May 31, 19X6, are available; accordingly, the procedures carried out by us with respect to changes in financial statement items after May 31, 19X6, have, of necessity, been even more limited than those with respect to the periods referred to in 4. We have inquired of certain officials of the company who have responsibility for financial and accounting matters whether (*a*) at June 23, 19X6, there was any change in the capital stock, increase in long-term debt or any decreases in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown on the March 31, 19X6, unaudited condensed consolidated balance sheet included in the registration statement or (*b*) for the period from April 1, 19X6, to June 23, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income. On the basis of these inquiries and our reading of the minutes as described in 4, nothing came to our attention that caused us to believe that there was any such change, increase, or decrease, except in all instances for changes, increases, or decreases that the registration statement discloses have occurred or may occur.

7. This letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the registration statement, and it is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the registration statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the registration statement.

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[6] Section 722 does not require the accountants to modify the report on a review of interim financial information for a lack of consistency in the application of accounting principles provided that the interim financial information appropriately discloses such matters.

Example B: Letter When a Short-Form Registration Statement Is Filed Incorporating Previously Filed Forms 10-K and 10-Q by Reference

3. Example B is applicable when a registrant uses a short-form registration statement (Form S-2 or S-3) which, by reference, incorporates previously filed Forms 10-K and 10-Q. It assumes that the short-form registration statement and prospectus include the Form 10-K for the year ended December 31, 19X5, and Form 10-Q for the quarter ended March 31, 19X6, which have been incorporated by reference. In addition to the information presented below, the letter would also contain paragraphs 6 and 7 of the typical letter in example A. A Form S-2 registration statement will often both incorporate and include the registrant's financial statements. In such situations, the language in the following example should be appropriately modified to refer to such information as being both incorporated and included.

June 28, 19X6

[*Addressee*]

Dear Sirs:

We have audited the consolidated balance sheets of The Blank Company, Inc. (the company) and subsidiaries as of December 31, 19X5 and 19X4, and the consolidated statements of income, retained earnings (stockholders' equity), and cash flows for each of the three years in the period ended December 31, 19X5, and the related financial statement schedules, all included (incorporated by reference) in the company's annual report on Form 10-K for the year ended December 31, 19X5, and incorporated by reference in the registration statement (no. 33-00000) on Form S-3 filed by the company under the Securities Act of 1933 (the Act); our report with respect thereto is also incorporated by reference in that registration statement. The registration statement, as amended on June 28, 19X6, is herein referred to as the registration statement.

In connection with the registration statement—

1. We are independent certified public accountants with respect to the company within the meaning of the Act and the applicable rules and regulations thereunder adopted by the SEC.

2. In our opinion, the consolidated financial statements and financial statement schedules audited by us and incorporated by reference in the registration statement comply as to form in all material respects with the applicable accounting requirements of the Act and the Securities Exchange Act of 1934 and the related rules and regulations adopted by the SEC.

3. We have not audited any financial statements of the company as of any date or for any period subsequent to December 31, 19X5; although we have conducted an audit for the year ended December 31, 19X5, the purpose (and therefore the scope) of the audit was to enable us to express our opinion on the consolidated financial statements as of December 31, 19X5, and for the year then ended, but not on the consolidated financial statements for any interim period within that year. Therefore, we are unable to and do not express any opinion on the unaudited condensed consolidated balance sheet as of March 31, 19X6, and the unaudited condensed consolidated statements of income, retained earnings (stockholders' equity), and cash flows for the three-month periods ended March 31, 19X6 and 19X5, included in the company's quarterly report on Form 10-Q for the quarter ended March 31, 19X6, incorporated by reference in the registration statement, or on the financial position, results of operations, or cash flows as of any date or for any period subsequent to December 31, 19X5.

4. For purposes of this letter, we have read the 19X6 minutes of the meetings of the stockholders, the board of directors, and [*include other appropriate committees, if any*] of the company and its subsidiaries as set forth in the minute books at June 23, 19X6, officials of the company having advised us that the minutes of all such meetings[7] through that date were set forth therein; we have carried out other procedures to June 23, 19X6, as follows (our work did not extend to the period from June 24, 19X6, to June 28, 19X6, inclusive):

a. With respect to the three-month periods ended March 31, 19X6 and 19X5, we have—

(i) Performed the procedures specified by the American Institute of Certified Public Accountants for a review of interim financial information as described in SAS No. 71, *Interim Financial Information*, on the unaudited condensed consolidated financial statements for these periods, described in 3, included in the company's quarterly report on Form 10-Q for the quarter ended March 31, 19X6, incorporated by reference in the registration statement.

(ii) Inquired of certain officials of the company who have responsibility for financial and accounting matters whether the unaudited condensed consolidated financial statements referred to in *a*(i) comply as to form in all material respects with the applicable accounting requirements of the Securities Exchange Act of 1934 as it applies to Form 10-Q and the related rules and regulations adopted by the SEC.

b. With respect to the period from April 1, 19X6, to May 31, 19X6, we have—

(i) Read the unaudited consolidated financial statements[8] of the company and subsidiaries for April and May of both 19X5 and 19X6 furnished us by the company, officials of the company having advised us that no such financial statements as of any date or for any period subsequent to May 31, 19X6, were available.

(ii) Inquired of certain officials of the company who have responsibility for financial and accounting matters whether the unaudited consolidated financial statements referred to in *b*(i) are stated on a basis substantially consistent with that of the audited consolidated financial statements incorporated by reference in the registration statement.

The foregoing procedures do not constitute an audit conducted in accordance with generally accepted auditing standards. Also, they would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representations about the sufficiency of the foregoing procedures for your purposes.

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[7] See footnote 3 of the Appendix.

[8] See footnote 4 of the Appendix.

5. Nothing came to our attention as a result of the foregoing procedures, however, that caused us to believe that—

a.

(i) Any material modifications should be made to the unaudited condensed consolidated financial statements described in 3, incorporated by reference in the registration statement, for them to be in conformity with generally accepted accounting principles.

(ii) The unaudited condensed consolidated financial statements described in 3 do not comply as to form in all material respects with the applicable accounting requirements of the Securities Exchange Act of 1934 as it applies to Form 10-Q and the related rules and regulations adopted by the SEC.

b.

(i) At May 31, 19X6, there was any change in the capital stock, increase in long-term debt, or any decreases in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown in the March 31, 19X6 unaudited condensed consolidated balance sheet incorporated by reference in the registration statement or

(ii) for the period from April 1, 19X6, to May 31, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income, except in all instances for changes, increases, or decreases that the registration statement discloses have occurred or may occur.

Example C: Letter Reaffirming Comments in Example A as of a Later Date

4. If more than one comfort letter is requested, the later letter may, in appropriate situations, refer to information appearing in the earlier letter without repeating such information (see paragraph .24 and paragraph 1 of the Appendix). Example C reaffirms and updates the information in example A.

July 25, 19X6

[*Addressee*]

Dear Sirs:

We refer to our letter of June 28, 19X6, relating to the registration statement (no. 33-00000) of The Blank Company, Inc. (the company). We reaffirm as of the date hereof (and as though made on the date hereof) all statements made in that letter except that, for the purposes of this letter—

a. The registration statement to which this letter relates is as amended on July 13, 19X6 [*effective date*].

b. The reading of minutes described in paragraph 4 of that letter has been carried out through July 20, 19X6 [*the new cutoff date*].

c. The procedures and inquiries covered in paragraph 4 of that letter were carried out to July 20, 19X6 [*the new cutoff date*] (our work did not extend to the period from July 21, 19X6, to July 25, 19X6 [*date of letter*], inclusive).

d. The period covered in paragraph 4*b* of that letter is changed to the period from April 1, 19X6, to June 30, 19X6, officials of the company having advised us that no such financial statements as of any date or for any period subsequent to June 30, 19X6, were available.

e. The references to May 31, 19X6, in paragraph 5*b* of that letter are changed to June 30, 19X6.

f. The references to May 31, 19X6, and June 23, 19X6, in paragraph 6 of that letter are changed to June 30, 19X6, and July 20, 19X6, respectively.

This letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the registration statement, and it is not to be used, circulated, quoted, or otherwise referred to within the underwriting group for any other purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the registration statement or any other document, except that reference may be made to it in the underwriting agreement or any list of closing documents pertaining to the offering of the securities covered by the registration statement.

Example D: Comments on Pro Forma Financial Information

5. Example D is applicable when the accountants are asked to comment on (*a*) whether the pro forma financial information included in a registration statement complies as to form in all material respects with the applicable accounting requirements of rule 11-02 of Regulation S-X, and (*b*) the application of pro forma adjustments to historical amounts in the compilation of the pro forma financial information (see paragraphs .42 and .43). The material in this example is intended to be inserted between paragraphs 6 and 7 in example A. The accountants have audited the December 31, 19X5, financial statements and have conducted an SAS No. 71 [section 722] review of the March 31, 19X6, interim financial information of the acquiring company. Other accountants conducted a review of the March 31, 19X6, interim financial information of XYZ Company, the company being acquired. The example assumes that the accountants have not previously reported on the pro forma financial information. If the accountants did previously report on the pro forma financial information, they may refer in the introductory paragraph of the comfort letter to the fact that they have issued a report, and the report may be attached to the comfort letter (see paragraph .29). In that circumstance, therefore, the procedures in 7*b*(i) and 7c ordinarily would not be performed, and the accountants should not separately comment on the application of pro forma adjustments to historical financial information, since that assurance is encompassed in the accountants' report on pro forma financial information. The accountants may, however, agree to comment on compliance as to form with the applicable accounting requirements of rule 11-02 of Regulation S-X.

7. At your request, we have—

a. Read the unaudited pro forma condensed consolidated balance sheet as of March 31, 19X6, and the unaudited pro forma condensed consolidated statements of income for the year ended December 31, 19X5, and the three-month period ended March 31, 19X6, included in the registration statement.

b. Inquired of certain officials of the company and of XYZ Company (the company being acquired) who have responsibility for financial and accounting matters about—

(i) The basis for their determination of the pro forma adjustments, and

(ii) Whether the unaudited pro forma condensed consolidated financial statements referred to in 7a comply as to form in all material respects with the applicable accounting requirements of rule 11-02 of Regulation S-X.

c. Proved the arithmetic accuracy of the application of the pro forma adjustments to the historical amounts in the unaudited pro forma condensed consolidated financial statements.

The foregoing procedures are substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assumptions, the pro forma adjustments, and the application of those adjustments to historical financial information. Accordingly, we do not express such an opinion. The foregoing procedures would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representation about the sufficiency of such procedures for your purposes.

8. Nothing came to our attention as a result of the procedures specified in paragraph 7, however, that caused us to believe that the unaudited pro forma condensed consolidated financial statements referred to in 7*a* included in the

registration statement do not comply as to form in all material respects with the applicable accounting requirements of rule 11-02 of Regulation S-X and that the pro forma adjustments have not been properly applied to the historical amounts in the compilation of those statements. Had we performed additional procedures or had we made an examination of the pro forma condensed consolidated financial statements, other matters might have come to our attention that would have been reported to you.

Example E: Comments on a Financial Forecast

6. Example E is applicable when accountants are asked to comment on a financial forecast (see paragraph .44). The material in this example is intended to be inserted between paragraphs 6 and 7 in example A. The example assumes that the accountants have previously reported on the compilation of the financial forecast and that the report is attached to the letter (see paragraph .29 and example O).

> 7. At your request, we performed the following procedure with respect to the forecasted consolidated balance sheet and consolidated statements of income and cash flows as of December 31, 19X6, and for the year then ending. With respect to forecasted rental income, we compared the occupancy statistics about expected demand for rental of the housing units to statistics for existing comparable properties and found them to be the same.
>
> 8. Because the procedure described above does not constitute an examination of prospective financial statements in accordance with standards established by the American Institute of Certified Public Accountants, we do not express an opinion on whether the prospective financial statements are presented in conformity with AICPA presentation guidelines or on whether the underlying assumptions provide a reasonable basis for the presentation.
>
> Had we performed additional procedures or had we made an examination of the forecast in accordance with standards established by the American Institute of Certified Public Accountants, matters might have come to our attention that would have been reported to you. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.

Example F: Comments on Tables, Statistics, and Other Financial Information—Complete Description of Procedures and Findings

7. Example F is applicable when the accountants are asked to comment on tables, statistics, or other compilations of information appearing in a registration statement (paragraphs .54 through .60). Each of the comments is in response to a specific request. The paragraphs in example F are intended to follow paragraph 6 in example A.

7. For purposes of this letter, we have also read the following, set forth in the registration statement on the indicated pages.[9]

Item	*Page*	*Description*
a	4	"Capitalization." The amounts under the captions "Amount Outstanding as of June 15, 19X6" and "As Adjusted." The related notes, except the following in Note 2: "See 'Transactions With Interested Persons.' From the proceeds of this offering the company intends to prepay $900,000 on these notes, pro rata. See 'Use of Proceeds.'"
b	13	"History and Business—Sales and Marketing." The table following the first paragraph.
c	22	"Executive Compensation—19X5 Compensation."
d	33	"Selected Financial Data."[10]

8. Our audit of the consolidated financial statements for the periods referred to in the introductory paragraph of this letter comprised audit tests and procedures deemed necessary for the purpose of expressing an opinion on such financial statements taken as a whole. For none of the periods referred to therein, or any other period, did we perform audit tests for the purpose of expressing an opinion on individual balances of accounts or summaries of selected transactions such as those enumerated above, and, accordingly, we express no opinion thereon.

9. However, for purposes of this letter we have performed the following additional procedures, which were applied as indicated with respect to the items enumerated above.

Item in 7 — *Procedures and Findings*

a We compared the amounts and numbers of shares listed under the caption "Amount Outstanding as of June 15, 19X6" with the balances in the appropriate accounts in the company's general ledger at May 31, 19X6 (the latest date for which posting had been made), and found them to be in

[9] In some cases it may be considered desirable to combine in one paragraph the substance of paragraphs 7 and 9. This may be done by expanding the identification of items in paragraph 9 to provide the identification information contained in paragraph 7. In such cases, the introductory sentences in paragraphs 7 and 9 and the text of paragraph 8 might be combined as follows: "For purposes of this letter, we have also read the following information and have performed the additional procedures stated below with respect to such information. Our audit of the consolidated financial statements. . ."

[10] In some cases the company or the underwriter may request that the independent accountants report on "selected financial data" as described in section 552, *Reporting on Condensed Financial Statements and Selected Financial Data*. When the accountants report on this data and the report is included in the registration statement, separate comments should not be included in the comfort letter (see paragraph .30).

Item in 7	*Procedures and Findings*

agreement. We were informed by company officials who have responsibility for financial and accounting matters that there have been no changes in such amounts and numbers of shares between May 31, 19X6, and June 15, 19X6. We compared the amounts and numbers of shares listed under the caption "Amount Outstanding as of June 15, 19X6," adjusted for the issuance of the debentures to be offered by means of the registration statement and for the proposed use of a portion of the proceeds thereof to prepay portions of certain notes, as described under "Use of Proceeds," with the amounts and numbers of shares shown under the caption "As Adjusted" and found such amounts and numbers of shares to be in agreement. (However, we make no comments regarding the reasonableness of the "Use of Proceeds" or whether such use will actually take place.) We compared the description of the securities and the information (except certain information in Note 2, referred to in 7) included in the notes to the table with the corresponding descriptions and information in the company's consolidated financial statements, including the notes thereto included in the registration statement, and found such description and information to be in agreement.

b We compared the amounts of military sales, commercial sales, and total sales shown in the registration statement with the balances in the appropriate accounts in the company's accounting records for the respective fiscal years and for the unaudited interim periods and found them to be in agreement. We proved the arithmetic accuracy of the percentages of such amounts of military sales and commercial sales to total sales for the respective fiscal years and for the unaudited interim periods. We compared such computed percentages with the corresponding percentages appearing in the registration statement and found them to be in agreement.

c We compared the dollar amounts of compensation (salary, bonus, and other compensation) for each individual listed in the table "Annual Compensation" with the corresponding amounts shown by the individual employee earnings records for the year 19X5 and found them to be in agreement. We compared the dollar amount of aggregate executive officers' cash compensation on page 22 with the corresponding amount shown in an analysis prepared by the company and found the amounts to be in agreement. We traced every item over $10,000 on the analysis to the individual employee records for 19X5. We compared the dollar amounts shown under the heading of "Long-Term Compensation" on page 24 for each listed individual and the aggregate amounts for executive officers with corresponding amounts shown in an analysis prepared by the company and found such amounts to be in agreement.

We compared the executive compensation information with the requirements of item 402 of Regulation S-K. We also inquired of certain officials of the company who have responsibility for financial and accounting matters whether the executive compensation information conforms in all material respects with the disclosure requirements of item 402 of Regulation S-K. Nothing came to our attention as a result of the foregoing procedures that caused us to believe that this information does not conform in all material respects with the disclosure requirements of item 402 of Regulation S-K.

d We compared the amounts of net sales, income from continuing operations, income from continuing operations per common share, and cash dividends declared per common share for the years ended December 31, 19X5, 19X4, and 19X3, with the respective amounts in the consolidated financial statements on pages 27 and 28 and the amounts for the years ended December 31, 19X2, and 19X1, with the respective amounts in the consolidated

Item in 7	*Procedures and Findings*
	financial statements included in the company's annual reports to stockholders for 19X2 and 19X1 and found them to be in agreement.
	We compared the amounts of total assets, long-term obligations, and redeemable preferred stock at December 31, 19X5 and 19X4, with the respective amounts in the consolidated financial statements on pages 27 and 28 and the amounts at December 31, 19X3, and 19X2, and 19X1 with the corresponding amounts in the consolidated financial statements included in the company's annual reports to stockholders for 19X3, 19X2, and 19X1 and found them to be in agreement.
	We compared the information included under the heading "Selected Financial Data" with the requirements of item 301 of Regulation S-K. We also inquired of certain officials of the company who have responsibility for financial and accounting matters whether this information conforms in all material respects with the disclosure requirements of item 301 of Regulation S-K. Nothing came to our attention as a result of the foregoing procedures that caused us to believe that this information does not conform in all material respects with the disclosure requirements of item 301 of Regulation S-K.

10. It should be understood that we make no representations regarding questions of legal interpretation or regarding the sufficiency for your purposes of the procedures enumerated in the preceding paragraph; also, such procedures would not necessarily reveal any material misstatement of the amounts or percentages listed above. Further, we have addressed ourselves solely to the foregoing data as set forth in the registration statement and make no representations regarding the adequacy of disclosure or regarding whether any material facts have been omitted.

11. This letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the registration statement, and it is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any other purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the registration statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the registration statement.

Example G: Comments on Tables, Statistics, and Other Financial Information—Summarized Description of Procedures and Findings Regarding Tables, Statistics, and Other Financial Information

8. Example G illustrates, in paragraph 9*a*, a method of summarizing the descriptions of procedures and findings regarding tables, statistics, and other financial information in order to avoid repetition in the comfort letter. The summarization of the descriptions is permitted by paragraph .58. Each of the comments is in response to a specific request. The paragraphs in example G are intended to follow paragraph 6 in example A.[11]

7. For purposes of this letter, we have also read the following, set forth in the registration statement on the indicated pages.

Item	*Page*	*Description*
a	4	"Capitalization." The amounts under the captions "Amount Outstanding as of June 15, 19X6" and "As Adjusted." The related notes, except the following in Note 2: "See 'Transactions With Interested Persons.' From the proceeds of this offering the company intends to prepay $900,000 on these notes, pro rata. See 'Use of Proceeds.'"
b	13	"History and Business—Sales and Marketing." The table following the first paragraph.
c	22	"Executive Compensation—19X5 Compensation."
d	33	"Selected Financial Data."[12]

8. Our audit of the consolidated financial statements for the periods referred to in the introductory paragraph of this letter comprised audit tests and procedures deemed necessary for the purpose of expressing an opinion on such financial statements taken as a whole. For none of the periods referred to therein, or any other period, did we perform audit tests for the purpose of expressing an opinion on individual balances of accounts or summaries of selected transactions such as those enumerated above, and, accordingly, we express no opinion thereon.

9. However, for purposes of this letter and with respect to the items enumerated in 7 above—

a. Except for item 7*a*, we have (i) compared the dollar amounts either with the amounts in the audited consolidated financial statements described in the introductory paragraph of this letter or, for prior years, included in the company's annual report to stockholders for the years 19X1, 19X2, and 19X3, or with amounts in the unaudited consolidated financial statements described in paragraph 3 to the extent such amounts are included in or can be derived from such statements and found them to be in agreement; (ii) compared the amounts of military

[11] Other methods of summarizing the descriptions may also be appropriately used. For example, the letter may present a matrix listing the financial information and common procedures employed and indicating the procedures applied to specific items.

[12] See footnote 10 of the Appendix.

sales, commercial sales, and total sales and the dollar amounts of compensation for each listed individual with amounts in the company's accounting records and found them to be in agreement; (iii) compared other dollar amounts with amounts shown in analyses prepared by the company and found them to be in agreement; and (iv) proved the arithmetic accuracy of the percentages based on the data in the above-mentioned financial statements, accounting records, and analyses.

We compared the information in items 7*c* and 7*d* with the disclosure requirements of Regulation S-K. We also inquired of certain officials of the company who have responsibility for financial and accounting matters whether this information conforms in all material respects with the disclosure requirements of Regulation S-K. Nothing came to our attention as a result of the foregoing procedures that caused us to believe that this information does not conform in all material respects with the disclosure requirements of items 402 and 301, respectively, of Regulation S-K.

b. With respect to item 7*a*, we compared the amounts and numbers of shares listed under the caption "Amount Outstanding as of June 15, 19X6" with the balances in the appropriate accounts in the company's general ledger at May 31, 19X6 (the latest date for which postings had been made), and found them to be in agreement. We were informed by officials of the company who have responsibility for financial and accounting matters that there had been no changes in such amounts and numbers of shares between May 31, 19X6, and June 15, 19X6. We compared the amounts and numbers of shares listed under the caption "Amount Outstanding as of June 15, 19X6" adjusted for the issuance of the debentures to be offered by means of the registration statement and for the proposed use of a portion of the proceeds thereof to prepay portions of certain notes, as described under "Use of Proceeds," with the amounts and numbers of shares shown under the caption "As Adjusted" and found such amounts and numbers of shares to be in agreement. (However, we make no comments regarding the reasonableness of "Use of Proceeds" or whether such use will actually take place.) We compared the description of the securities and the information (except certain information in Note 2, referred to in 7) included in the notes to the table with the corresponding descriptions and information in the company's consolidated financial statements, including the notes thereto, included in the registration statement and found such descriptions and information to be in agreement.

10. It should be understood that we make no representations regarding questions of legal interpretation or regarding the sufficiency for your purposes of the procedures enumerated in the preceding paragraph; also, such procedures would not necessarily reveal any material misstatement of the amounts or percentages listed above. Further, we have addressed ourselves solely to the foregoing data as set forth in the registration statement and make no representations regarding the adequacy of disclosure or regarding whether any material facts have been omitted.

11. This letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the registration statement, and it is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any other purpose,

including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the registration statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the registration statement.

Example H: Comments on Tables, Statistics, and Other Financial Information: Descriptions of Procedures and Findings Regarding Tables, Statistics, and Other Financial Information—Attached Registration Statement (or Selected Pages) Identifies With Designated Symbols Items to Which Procedures Were Applied

9. This example illustrates an alternate format which could facilitate reporting when the accountant is requested to perform procedures on numerous statistics included in a registration statement. This format is permitted by paragraph .58. Each of the comments is in response to a specific request. The paragraph in example H is intended to follow paragraph 6 in example A.

> 7. For purposes of this letter, we have also read the items identified by you on the attached copy of the registration statement (prospectus), and have performed the following procedures, which were applied as indicated with respect to the symbols explained below:
>
> ✓ Compared the amount with the XYZ (Predecessor Company) financial statements for the period indicated and found them to be in agreement.
>
> ✓ Compared the amount with the XYZ (Predecessor Company) financial statements for the period indicated contained in the registration statement and found them to be in agreement.
>
> ✓ Compared the amount with ABC Company's financial statements for the period indicated contained in the registration statement and found them to be in agreement.
>
> ◯ Compared with a schedule or report prepared by the Company and found them to be in agreement.

The letter would also contain paragraphs 8, 10, and 11 of the letter in example F.

[*The following is an extract from a registration statement that illustrates how an accountant can document procedures performed on numerous statistics included in the registration statement.*]

> The following summary is qualified in its entirety by the financial statements and detailed information appearing elsewhere in this Prospectus.

The Company

ABC Company (the "Company") designs, constructs, sells, and finances single-family homes for the entry-level and move-up homebuyer. The Company and its predecessor have built and delivered more single-family homes in the metropolitan area than any other homebuilder for each of the last five years. The Company delivered 1,000 homes in the year ending December 31, 19X5, and at December 31, 19X5, had 500 homes[13] under contract with an aggregate sales price of approximately $45,000,000. The Company's wholly owned mortgage banking subsidiary, which commenced operations in March 19X5, currently originates a substantial portion of the mortgages for homes sold by the Company.

The Company typically does not engage in land development without related homebuilding operations and limits speculative building. The Company purchases only that land which it is prepared to begin developing immediately for home production. A substantial portion of the Company's homes are under contract for sale before construction commences.

The DEF area has been among the top five markets in the country in housing starts for each of the last five years, with more than 90,000 single-family starts during that period. During the same period, the DEF metropolitan area has experienced increases in population, personal income, and employment at rates above the national average. The Company is a major competitive factor in three of the seven market areas, and is expanding significantly in a fourth area.

The Offering

Stock Offered by the Company.....	750,000 shares of Common Stock—$.01 par value (the Common Stock")*
Common Stock to Be Outstanding.....	3,250,000 shares*
Use of Proceeds.....	To repay indebtedness incurred for the acquisition of the Company.
Proposed NASDAQ Symbol.....	ABC

Summary Financial Information
(In thousands, except per-share data)

	XYZ (Predecessor Company) Year Ended December 31,			*ABC Company Year Ended December 31,*	
Income Statement Data	*19X1*	*19X2*	*19X3*	*19X4*	*19X5*
Revenue from home sales	$106,603	$88,970	$104,110	$115,837	$131,032
Gross profit from sales	15,980	21,138	23,774	17,099	22,407
Income from home building net of tax	490	3,473	7,029	1,000	3,425
Earnings per share	—	—	—	—	$ 1.37

[13] See paragraph .55.

* Assumes no exercise of the Underwriters' overallotment option. See "Underwriting".

Example I: Alternate Wording When Accountants' Report on Audited Financial Statements Contains an Explanatory Paragraph

10. Example I is applicable when the accountants' report on the audited financial statements included in the registration statement contains an explanatory paragraph regarding a matter that would also affect the unaudited condensed consolidated interim financial statements included in the registration statement. The introductory paragraph of example A would be revised as follows:

> Our reports with respect thereto (which contain an explanatory paragraph that describes a lawsuit to which the Company is a defendant, discussed in note 8 to the consolidated financial statements) are also included in the registration statement.

The matter described in the explanatory paragraph should also be evaluated to determine whether it also requires mention in the comments on the unaudited condensed consolidated interim financial information (paragraph 5*b* of example A). If it is concluded that mention of such a matter in the comments on unaudited condensed consolidated financial statements is appropriate, a sentence should be added at the end of paragraph 5*b* in example A:

> Reference should be made to the introductory paragraph of this letter which states that our audit report covering the consolidated financial statements as of and for the year ended December 31, 19X5, includes an explanatory paragraph that describes a lawsuit to which the company is a defendant, discussed in note 8 to the consolidated financial statements.

Example J: Alternate Wording When More Than One Accountant Is Involved

11. Example J applies when more than one accountant is involved in the audit of the financial statements of a business and the principal accountants have obtained a copy of the comfort letter of the other accountants (see paragraph .18). Example J consists of an addition to paragraph 4*c*, a substitution for the applicable part of paragraph 5, and an addition to paragraph 6 of example A.

> [*4*]c. We have read the letter dated _____of [*the other accountants*] with regard to [*the related company*].
>
> 5. Nothing came to our attention as a result of the foregoing procedures (which, so far as [*the related company*] is concerned, consisted solely of reading the letter referred to in 4*c*), however, that caused us to believe that....
>
> 6. . . .On the basis of these inquiries and our reading of the minutes and the letter dated _____of [*the other accountants*] with regard to [*the related company*], as described in 4, nothing came to our attention that caused us to believe that there was any such change, increase, or decrease, except in all instances for changes, increases, or decreases that the registration statement discloses have occurred or may occur.

Example K: Alternate Wording When the SEC Has Agreed to a Departure From Its Accounting Requirements

12. Example K is applicable when (*a*) there is a departure from the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC and (*b*) representatives of the SEC have agreed to the departure. Paragraph 2 of example A would be revised to read as follows:

> 2. In our opinion [*include the phrase "except as disclosed in the registration statement," if applicable*], the consolidated financial statements and financial statement schedules audited by us and included (incorporated by reference) in the registration statement comply as to form in all material respects with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC; however, as agreed to by representatives of the SEC, separate financial statements and financial statement schedules of ABC Company (an equity investee) as required by rule 3-09 of Regulation S-X have been omitted.

Example L: Alternate Wording When Recent Earnings Data Are Presented in Capsule Form

13. Example L is applicable when (*a*) the statement of income in the registration statement is supplemented by later information regarding sales and earnings (capsule financial information), (*b*) the accountants are asked to comment on that information (paragraphs .39 through .41), and (*c*) the accountants have conducted a review in accordance with section 722 of the financial statements from which the capsule financial information is derived. The same facts exist as in example A, except for the following:

a. Sales, net income (no extraordinary items), and earnings per share for the six-month periods ended June 30, 19X6 and 19X5 (both unaudited), are included in capsule form more limited than that specified by APB Opinion 28 [AC section I73.146].

b. No financial statements later than those for June 19X6 are available.

c. The letter is dated July 25, 19X6, and the cutoff date is July 20, 19X6.

Paragraphs 4, 5, and 6 of example A should be revised to read as follows:

> 4. For purposes of this letter we have read the 19X6 minutes of the meetings of the stockholders, the board of directors, and [*include other appropriate committees, if any*] of the company and its subsidiaries as set forth in the minute books at July 20, 19X6, officials of the company having advised us that the minutes of all such meetings[14] through that date were set forth therein; we have carried out other procedures to July 20, 19X6, as follows (our work did not extend to the period from July 21, 19X6, to July 25, 19X6, inclusive):
>
> *a.* With respect to the three-month periods ended March 31, 19X6 and 19X5, we have—
>
> (i) Performed the procedures specified by the American Institute of Certified Public Accountants for a review of interim financial information as described in SAS No. 71, *Interim Financial Information*, on the unaudited condensed consolidated balance sheet as of March 31, 19X6, and the unaudited condensed consolidated statements of income, retained earnings (stockholders' equity), and cash flows for the three-month periods ended March 31, 19X6 and 19X5, included in the registration statement.
>
> (ii) Inquired of certain officials of the company who have responsibility for financial and accounting matters whether the unaudited condensed consolidated financial statements referred to in (i) comply as to form in all material respects with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC.
>
> *b.* With respect to the six-month periods ended June 30, 19X6 and 19X5, we have—
>
> (i) Read the unaudited amounts for sales, net income, and earnings per share for the six-month periods

[14] See footnote 3 of the Appendix.

ended June 30, 19X6 and 19X5, as set forth in paragraph [*identify location*].

(ii) Performed the procedures specified by the American Institute of Certified Public Accountants for a review of financial information as described in SAS No. 71, *Interim Financial Information*, on the unaudited condensed consolidated balance sheet as of June 30, 19X6 and the unaudited condensed consolidated statements of income, retained earnings (stockholders' equity), and cash flows for the six-month periods ended June 30, 19X6 and 19X5 from which the unaudited amounts referred to in *b*(i) are derived.

(iii) Inquired of certain officials of the company who have responsibility for financial and accounting matters whether the unaudited amounts referred to in (i) are stated on a basis substantially consistent with that of the corresponding amounts in the audited consolidated statements of income.

The foregoing procedures do not constitute an audit conducted in accordance with generally accepted auditing standards. Also, they would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representations regarding the sufficiency of the foregoing procedures for your purposes.

5. Nothing came to our attention as a result of the foregoing procedures, however, that caused us to believe that—

a.

(i) Any material modifications should be made to the unaudited condensed consolidated financial statements described in 4*a*(i), included in the registration statement, for them to be in conformity with generally accepted accounting principles.

(ii) The unaudited condensed consolidated financial statements described in 4*a*(i) do not comply as to form in all material respects with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC.

b.

(i) The unaudited amounts for sales, net income and earnings per share for the six-month periods ended June 30, 19X6 and 19X5, referred to in 4*b*(i) do not agree with the amounts set forth in the unaudited consolidated financial statements for those same periods.

(ii) The unaudited amounts referred to in *b*(i) were not determined on a basis substantially consistent with that of the corresponding amounts in the audited consolidated statements of income.

c. At June 30, 19X6, there was any change in the capital stock, increase in long-term debt or any decreases in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown in the March 31, 19X6, unaudited condensed consolidated balance sheet included in the

registration statement, except in all instances for changes, increases, or decreases that the registration statement discloses have occurred or may occur.

6. Company officials have advised us that no consolidated financial statements as of any date or for any period subsequent to June 30, 19X6, are available; accordingly, the procedures carried out by us with respect to changes in financial statement items after June 30, 19X6, have been, of necessity, even more limited than those with respect to the periods referred to in 4. We have inquired of certain officials of the company who have responsibility for financial and accounting matters regarding whether (*a*) at July 20, 19X6, there was any change in the capital stock, increase in long-term debt or any decreases in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown on the March 31, 19X6 unaudited condensed consolidated balance sheet included in the registration statement; or (*b*) for the period from July 1, 19X6, to July 20, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income. On the basis of these inquiries and our reading of the minutes as described in 4, nothing came to our attention that caused us to believe that there was any such change, increase, or decrease, except in all instances for changes, increases, or decreases that the registration statement discloses have occurred or may occur.

Example M: Alternate Wording When Accountants Are Aware of a Decrease in a Specified Financial Statement Item

14. Example M covers a situation in which accountants are aware of a decrease in a financial statement item on which they are requested to comment (see paragraphs .45 through .53). The same facts exist as in example A, except for the decrease covered in the following change in paragraph 5*b*.

b.

(i) At May 31, 19X6, there was any change in the capital stock, increase in long-term debt or any decrease in consolidated stockholders' equity of the consolidated companies as compared with amounts shown in the March 31, 19X6, unaudited condensed consolidated balance sheet included in the registration statement, or

(ii) for the period from April 1, 19X6, to May 31, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or the total or per-share amounts of income before extraordinary items or of net income, except in all instances for changes, increases, or decreases that the registration statement discloses have occurred or may occur and except that the unaudited consolidated balance sheet as of May 31, 19X6, which we were furnished by the company, showed a decrease from March 31, 19X6, in consolidated net current assets as follows (in thousands of dollars):

	Current Assets	*Current Liabilities*	*Net Current Assets*
March 31, 19X6	$4,251	$1,356	$2,895
May 31, 19X6	3,986	1,732	2,254

6. As mentioned in 4*b*, company officials have advised us that no consolidated financial statements as of any date or for any period subsequent to May 31, 19X6, are available; accordingly, the procedures carried out by us with respect to changes in financial statement items after May 31, 19X6, have been, of necessity, even more limited than those with respect to the periods referred to in 4. We have inquired of certain officials of the company who have responsibility for financial and accounting matters regarding whether (*a*) there was any change at June 23, 19X6, in the capital stock, increase in long-term debt or any decreases in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown on the March 31, 19X6, unaudited condensed consolidated balance sheet included in the registration statement; or (*b*) for the period from April 1, 19X6, to June 23, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income. On the basis of these inquiries and our reading of the minutes as described in 4, nothing came to our attention that caused us to believe that there was any such change, increase, or decrease, except in all instances for changes, increases, or decreases that the registration statement discloses have occurred or may occur and except as described in the following sentence. We have been informed by officials of the company that there continues to be a decrease in net current assets that is estimated to be approximately the same amount as set forth in 5*b* [*or whatever other disclosure fits the circumstances*].

Example N: Alternate Wording of the Letter for Companies That Are Permitted to Present Interim Earnings Data for a Twelve-Month Period

15. Certain types of companies are permitted to include earnings data for a twelve-month period to the date of the latest balance sheet furnished in lieu of earnings data for both the interim period between the end of the latest fiscal year and the date of the latest balance sheet and the corresponding period of the preceding fiscal year. The following would be substituted for the applicable part of paragraph 3 of example A.

> 3. . . .was to enable us to express our opinion on the financial statements as of December 31, 19X5, and for the year then ended, but not on the financial statements for any period included in part within that year. Therefore, we are unable to and do not express any opinion on the unaudited condensed consolidated balance sheet as of March 31, 19X6, and the related unaudited condensed consolidated statements of income, retained earnings (stockholders' equity), and cash flows for the twelve months then ended included in the registration statement. . . .

Example O: Alternate Wording When the Procedures That the Underwriter Has Requested the Accountant to Perform on Interim Financial Information Are Less Than an SAS No. 71 Review

16. The example assumes that the underwriter has asked the accountants to perform specified procedures on the interim financial information and report thereon in the comfort letter. The letter is dated June 28, 19X6; procedures were performed through June 23, 19X6, the cutoff date. Since an SAS No. 71 [section 722] review was not performed on the interim financial information as of March 31, 19X6 and for the quarter then ended, the accountants are limited to reporting procedures performed and findings obtained on the interim financial information. In addition to the information presented below, the letter would also contain paragraph 7 of the typical comfort letter in example A.

June 28, 19X6

[*Addressee*]

Dear Sirs:

We have audited the consolidated balance sheets of The Blank Company, Inc. (the company) and the subsidiaries as of December 31, 19X5 and 19X4, and the consolidated statements of income, retained earnings (stockholders' equity), and cash flows for each of the three years in the period ended December 31, 19X5 and the related financial statement schedules all included in the registration statement (no. 33-00000) on Form S-1 filed by the company under the Securities Act of 1933 (the Act); our reports with respect thereto are included in that registration statement. The registration statement, as amended on June 28, 19X6, is herein referred to as the registration statement.

Also, we have compiled the forecasted balance sheet and consolidated statements of income, retained earnings (stockholders' equity), and cash flows as of December 31, 19X6 and for the year then ending, attached to the registration statement, as indicated in our report dated May 15, 19X6, which is attached.

In connection with the registration statement—

1. We are independent certified public accountants with respect to the company within the meaning of the Act and the applicable rules and regulations thereunder adopted by the SEC.

2. In our opinion [*include the phrase "except as disclosed in the registration statement," if applicable*], the consolidated financial statements and financial statement schedules audited by us and included in the registration statement comply as to form in all material respects with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC.

3. We have not audited any financial statements of the company as of any date or for any period subsequent to December 31, 19X5; although we have conducted an audit for the year ended December 31, 19X5, the purpose (and therefore the scope) of the audit was to enable us to express our opinion on the consolidated financial statements as of December 31, 19X5, and for the year then ended, but not on the financial statements for any interim period within that year. Therefore, we are unable to and do not express any opinion on the unaudited condensed consolidated balance sheet as of March 31, 19X6, and the unaudited condensed consolidated statements of income, retained earnings (stockholders' equity), and cash flows for the three-month periods ended March 31, 19X6 and 19X5, included in the registration statement, or on the financial

position, results of operations, or cash flows as of any date or for any period subsequent to December 31, 19X5.

4. For purposes of this letter, we have read the 19X6 minutes of meetings of the stockholders, the board of directors, and [*include other appropriate committees, if any*] of the company as set forth in the minute books at June 23, 19X6, officials of the company having advised us that the minutes of all such meetings[15] through that date were set forth therein; we have carried out other procedures to June 23, 19X6, as follows (our work did not extend to the period from June 24, 19X6, to June 28, 19X6, inclusive):

a. With respect to the three-month periods ended March 31, 19X6 and 19X5, we have—

(i) Read the unaudited condensed consolidated balance sheet as of March 31, 19X6, and unaudited condensed consolidated statements of income, retained earnings (stockholders' equity), and cash flows for the three-month periods ended March 31, 19X6 and 19X5, included in the registration statement, and agreed the amounts contained therein with the company's accounting records as of March 31, 19X6 and 19X5, and for the three-month periods then ended.

(ii) Inquired of certain officials of the company who have responsibility for financial and accounting matters whether the unaudited condensed consolidated financial statements referred to in *a*(i): (1) are in conformity with generally accepted accounting principles[16] applied on a basis substantially consistent with that of the audited consolidated financial statements included in the registration statement, and (2) comply as to form in all material respects with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC. Those officials stated that the unaudited condensed consolidated financial statements (1) are in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited financial statements, and (2) comply as to form in all material respects with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC.

b. With respect to the period from April 1, 19X6, to May 31, 19X6, we have—

(i) Read the unaudited condensed consolidated financial statements of the company[17] for April and May of both 19X5 and 19X6 furnished us by the company, and agreed the amounts contained therein to the company's accounting records. Officials of the company have advised us that no such financial statements as of any date or for any period subsequent to May 31, 19X6, were available.

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[15] See footnote 3 of the Appendix.

[16] See footnote 5 of the Appendix.

[17] See footnote 4 of the Appendix.

(ii) Inquired of certain officials of the company who have responsibility for financial and accounting matters whether (1) the unaudited financial statements referred to in *b*(i) are stated on a basis substantially consistent with that of the audited consolidated financial statements included in the registration statement, (2) at May 31, 19X6, there was any change in the capital stock, increase in long-term debt or any decrease in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown in the March 31, 19X6 unaudited condensed consolidated balance sheet included in the registration statement, and (3) for the period from April 1, 19X6, to May 31, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income.

Those officials stated that (1) the unaudited consolidated financial statements referred to in 4*b*(i) are stated on a basis substantially consistent with that of the audited consolidated financial statements included in the registration statement, (2) at May 31, 19X6, there was no change in the capital stock, no increase in long-term debt, and no decrease in net current assets or stockholders' equity of the consolidated companies as compared with amounts shown in the March 31, 19X6, unaudited condensed consolidated balance sheet included in the registration statement, and (3) there were no decreases for the period from April 1, 19X6, to May 31, 19X6, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income.

c. As mentioned in 4*b*(i), company officials have advised us that no financial statements as of any date or for any period subsequent to May 31, 19X6, are available; accordingly, the procedures carried out by us with respect to changes in financial statement items after May 31, 19X6, have, of necessity, been even more limited than those with respect to the periods referred to in 4*a* and 4*b*. We have inquired of certain officials of the company who have responsibility for financial and accounting matters whether (*a*) at June 23, 19X6, there was any change in the capital stock, increase in long-term debt or any decreases in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown on the March 31, 19X6, unaudited condensed consolidated balance sheet included in the registration statement, or (*b*) for the period from April 1, 19X6, to June 23, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income. Those officials stated that (1) at June 23, 19X6, there was no change in the capital stock, no increase in long-term debt and no decreases in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown on the March 31, 19X6, unaudited condensed consolidated balance sheet, and (2) for the period from April 1, 19X6, to June

23, 19X6, there were no decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income.

The foregoing procedures do not constitute an audit conducted in accordance with generally accepted auditing standards. We make no representations regarding the sufficiency of the foregoing procedures for your purposes. Had we performed additional procedures or had we conducted an audit or a review, other matters might have come to our attention that would have been reported to you.

5. At your request, we also performed the following procedures:

a. Read the unaudited pro forma condensed consolidated balance sheet as of March 31, 19X6, and the unaudited pro forma condensed consolidated statements of income for the year ended December 31, 19X5, and the three-month period ended March 31, 19X6, included in the registration statement.

b. Inquired of certain officials of the company and of XYZ Company (the company being acquired) who have responsibility for financial and accounting matters as to whether all significant assumptions regarding the business combination had been reflected in the pro forma adjustments and whether the unaudited pro forma condensed consolidated financial statements referred to in (*a*) comply as to form in all material respects with the applicable accounting requirements of rule 11-02 of Regulation S-X.

Those officials referred to above stated, in response to our inquiries, that all significant assumptions regarding the business combination had been reflected in the pro forma adjustments and that the unaudited pro forma condensed consolidated financial statements referred to in (*a*) comply as to form in all material respects with the applicable accounting requirements of rule 11-02 of Regulation S-X.

c. Compared the historical financial information for the company included on page 20 in the registration statement with historical financial information for the company on page 12 and found them to be in agreement.

We also compared the financial information included on page 20 of the registration statement with the historical information for XYZ Company on page 13 and found them to be in agreement.

d. Proved the arithmetic accuracy of the application of the pro forma adjustments to the historical amounts in the unaudited pro forma condensed consolidated financial statements.

The foregoing procedures are less in scope than an examination, the objective of which is the expression of an opinion on management's assumptions, the pro forma adjustments, and the application of those adjustments to historical financial information. Accordingly, we do not express such an opinion. We make no representation about the sufficiency of the foregoing procedures for your purposes. Had we performed additional procedures or had we made an examination of the pro forma financial information, other matters might have come to our attention that would have been reported to you.

6. At your request, we performed the following procedures with respect to the forecasted consolidated balance sheet and consolidated statements of income and cash flows as of December 31, 19X6, and for the year then ending. With respect to forecasted rental income, we compared the occupancy statistics about expected demand for rental of the housing units to statistics for existing comparable properties and found them to be the same.

Because the procedures described above do not constitute an examination of prospective financial statements in accordance with standards established by the American Institute of Certified Public Accountants, we do not express an opinion on whether the prospective financial statements are presented in conformity with AICPA presentation guidelines or on whether the underlying assumptions provide a reasonable basis for the presentation. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We make no representations about the sufficiency of such procedures for your purposes. Had we performed additional procedures or had we made an examination of the forecast in accordance with standards established by the AICPA, matters might have come to our attention that would have been reported to you.

Example P: A Typical Comfort Letter in a Non-1933 Act Offering, Including the Required Underwriter Representations

17. Example P is applicable when a comfort letter is issued in a non-1933 Act offering. The underwriter has given the accountants a letter including the representations regarding their due diligence review process, as described in paragraphs .06 and .07, and the comfort letter refers to those representations. In addition, the example assumes that the accountants were unable, or were not requested, to perform an SAS No. 71 [section 722] review of a subsequent interim period and therefore no negative assurance has been given. See paragraph .47.

November 30, 19X5

[*Addressee*]

Dear Sirs:

We have audited the balance sheets of Example City, Any State Utility System as of June 30, 19X5 and 19X4, and the statements of revenues, expenses, and changes in retained earnings and cash flows for the years then ended, included in the Official Statement for $30,000,000 of Example City, Any State Utility System Revenue Bonds due November 30, 19Z5. Our report with respect thereto is included in the Official Statement. This Official Statement, dated November 30, 19X5, is herein referred to as the Official Statement.

This letter is being furnished in reliance upon your representation to us that—

a. You are knowledgeable with respect to the due diligence review process that would be performed if this placement of securities were being registered pursuant to the Securities Act of 1933 (the Act).

b. In connection with the offering of revenue bonds, the review process you have performed is substantially consistent with the due diligence review process that you would have performed if this placement of securities were being registered pursuant to the Act.

In connection with the Official Statement—

1. We are independent certified public accountants with respect to Example City, Any State and its Utility System under rule 101 of the AICPA's *Code of Professional Conduct*, and its interpretations and rulings.

2. We have not audited any financial statements of Example City, Any State Utility System as of any date or for any period subsequent to June 30, 19X5; although we have conducted an audit for the year ended June 30, 19X5, the purpose (and therefore the scope) of the audit was to enable us to express our opinion on the financial statements as of June 30, 19X5, and for the year then ended, but not on the financial statements for any interim period within that year. Therefore, we are unable to and do not express any opinion on the financial position, results of operations, or cash flows as of any date or for any period subsequent to June 30, 19X5, for the Example City, Any State Utility System.

3. For purposes of this letter we have read the 19X5 minutes of the meetings of the City Council of Example City, Any State as set forth in the minutes books as of November 25, 19X5, the City Clerk of Example City having advised us that the minutes of all such meetings[18] through that date were set forth therein.

---

[18] See footnote 3 of paragraph .03.

4. With respect to the period subsequent to June 30, 19X5, we have carried out other procedures to November 25, 19X5, as follows (our work did not extend to the period from November 26, 19X5, to November 30, 19X5, inclusive):

- We have inquired of, and received assurance from, city officials who have responsibility for financial and accounting matters, that no financial statements as of any date or for any period subsequent to June 30, 19X5, are available.
- We have inquired of those officials regarding whether (*a*) at November 25, 19X5, there was any increase in long-term debt or any decrease in net current assets of Example City, Any State Utility System as compared with amounts shown on the June 30, 19X5, balance sheet, included in the Official Statement, or (*b*) for the period from July 1, 19X5, to November 25, 19X5, there were any decreases, as compared with the corresponding period in the preceding year, in total operating revenues, income from operations or net income. Those officials stated that (1) at November 25, 19X5, there was no increase in long-term debt and no decrease in net current assets of the Example City, Any State Utility System as compared with amounts shown in the June 30, 19X5, balance sheet; and (2) there were no decreases for the period from July 1, 19X5, to November 25, 19X5, as compared with the corresponding period in the preceding year, in total operating revenues, income from operations, or net income, except in all instances for changes, increases, or decreases that the Official Statement discloses have occurred or may occur.

5. For accounting data pertaining to the years 19X3 through 19X5, inclusive, shown on page 11 of the Official Statement, we have (i) for data shown in the audited financial statements, compared such data with the audited financial statements of the Example City, Any State Utility System for 19X3 through 19X5 and found them to be in agreement; and (ii) for data not directly shown in the audited financial statements, compared such data with the general ledger and accounting records of the Utility System from which such information was derived, and found them to be in agreement.

6. The procedures enumerated in the preceding paragraphs do not constitute an audit conducted in accordance with generally accepted auditing standards. Accordingly, we make no representations regarding the sufficiency of the foregoing procedures for your purposes.

7. This letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the Example City, Any State Utility System in connection with the offering of securities covered by the Official Statement, and it is not to be used, circulated, quoted, or otherwise referred to for any other purpose, including but not limited to the purchase or sale of securities, nor is it to be filed with or referred to in whole or in part in the Official Statement or any other document, except that reference may be made to it in the Purchase Contract or in any list of closing documents pertaining to the offering of securities covered by the Official Statement.

Example Q: Letter to a Requesting Party That Has Not Provided the Representation Letter Described in Paragraphs .06 and .07

18. This example assumes that these procedures are being performed at the request of the placement agent on information included in an offering circular in connection with a private placement of unsecured notes with two insurance companies.[19] The letter is dated June 30, 19X6; procedures were performed through June 25, 19X6, the cutoff date. The statements in paragraphs 5 through 9 of the example should be included in any letter issued pursuant to paragraph .09.[20]

June 30, 19X6

[*Addressee*]

Dear Sirs:

We have audited the consolidated balance sheets of The Blank Company, Inc. (the company) and subsidiaries as of December 31, 19X5 and 19X4, and the consolidated statements of income, retained earnings (stockholders' equity), and cash flows for each of the three years in the period ended December 31, 19X5, included in the offering circular for $30,000,000 of notes due June 30, 20X6. Our report with respect thereto is included in the offering circular. The offering circular dated June 30, 19X6, is herein referred to as the offering circular.

We are independent certified public accountants with respect to the company under rule 101 of the AICPA's Code of Professional Conduct, and its interpretations and rulings.[21]

We have not audited any financial statements of the company as of any date or for any period subsequent to December 31, 19X5; although we have conducted an audit for the year ended December 31, 19X5, the purpose (and, therefore, the scope) of the audit was to enable us to express our opinion on the consolidated financial statements as of December 31, 19X5, and for the year then ended, but not on the financial statements for any interim period within that year. Therefore, we are unable to and do not express any opinion on the unaudited condensed consolidated balance sheet as of March 31, 19X6, and the unaudited condensed consolidated statements of income, retained earnings (stockholders' equity), and cash flows for the three-month periods ended March 31, 19X6 and 19X5, included in the offering circular, or on the financial position, results of operations, or cash flows as of any date or for any period subsequent to December 31, 19X5.

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[19] This same example could be used in conjunction with a municipal bond offering in which the accountant has not received the representation letter described in paragraphs .06 and .07. [Footnote added, effective for letters issued pursuant to paragraph .09 of this section after April 30, 1996, by Statement on Auditing Standards No. 76.]

[20] This example may also be used in connection with a filing under the Securities Act of 1933 (the Act) when a party other than a named underwriter (for example, a selling shareholder) has not provided the accountant with the representation letter described in paragraphs .06 and .07. In such a situation, this example may be modified to include the accountant's comments on independence and compliance as to form of the audited financial statements and financial statement schedules with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC. Example paragraph 1*a*(ii) may include an inquiry, and the response of company officials, on compliance as to form of the unaudited condensed interim financial statements. [Footnote added, effective for letters issued pursuant to paragraph .09 of this section after April 30, 1996, by Statement on Auditing Standards No. 76.]

[21] See paragraphs .31 and .32 for guidance in commenting on independence. [Footnote added, effective for letters issued pursuant to paragraph .09 of this section after April 30, 1996, by Statement on Auditing Standards No. 76.]

1. At your request, we have read the 19X6 minutes of meetings of the stockholders, the board of directors, and [*include other appropriate committees, if any*] of the company as set forth in the minute books at June 25, 19X6, officials of the company having advised us that the minutes of all such meetings[22] through that date were set forth therein; we have carried out other procedures to June 25, 19X6 (our work did not extend to the period from June 26, 19X6, to June 30, 19X6, inclusive), as follows:

a. With respect to the three-month periods ended March 31, 19X6 and 19X5, we have—

(i) Read the unaudited condensed consolidated balance sheet as of March 31, 19X6, and the unaudited condensed consolidated statements of income, retained earnings (stockholders' equity), and cash flows[23, 24] of the company for the three-month periods ended March 31, 19X6 and 19X5, included in the offering circular, and agreed the amounts contained therein with the company's accounting records as of March 31, 19X6 and 19X5, and for the three-month periods then ended.

(ii) Inquired of certain officials of the company who have responsibility for financial and accounting matters whether the unaudited condensed consolidated financial statements referred to in *a*(i) are in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements included in the offering circular. Those officials stated that the unaudited condensed consolidated financial statements are in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited consolidated financial statements.

b. With respect to the period from April 1, 19X6, to May 31, 19X6, we have—

(i) Read the unaudited condensed consolidated financial statements of the company for April and May of both 19X5 and 19X6, furnished us by the company, and agreed the amounts contained therein with the company's accounting records. Officials of the company have advised us that no financial statements as of any date or for any period subsequent to May 31, 19X6, were available.

(ii) Inquired of certain officials of the company who have responsibility for financial and accounting matters whether (1) the unaudited condensed consolidated financial statements referred to in *b*(i) are stated on a basis substantially consistent with

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[22] See footnote 3 of the Appendix. [Footnote added, effective for letters issued pursuant to paragraph .09 of this section after April 30, 1996, by Statement on Auditing Standards No. 76.]

[23] See footnotes 4 and 5 of the Appendix. [Footnote added, effective for letters issued pursuant to paragraph .09 of this section after April 30, 1996, by Statement on Auditing Standards No. 76.]

[24] Generally, accountants should recognize that the criteria for summarized financial information have not been established for entities other than SEC registrants. [Footnote added, effective for letters issued pursuant to paragraph .09 of this section after April 30, 1996, by Statement on Auditing Standards No. 76.]

that of the audited consolidated financial statements included in the offering circular, (2) at May 31, 19X6, there was any change in the capital stock, increase in long-term debt or any decrease in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown in the March 31, 19X6, unaudited condensed consolidated balance sheet included in the offering circular, and (3) for the period from April 1, 19X6, to May 31, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income.

Those officials stated that (1) the unaudited condensed consolidated financial statements referred to in *b*(ii) are stated on a basis substantially consistent with that of the audited consolidated financial statements included in the offering circular, (2) at May 31, 19X6, there was no change in the capital stock, no increase in long-term debt, and no decrease in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown in the March 31, 19X6, unaudited condensed consolidated balance sheet included in the offering circular, and (3) there were no decreases for the period from April 1, 19X6, to May 31, 19X6, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income.

c. As mentioned in 1*b*, company officials have advised us that no financial statements as of any date or for any period subsequent to May 31, 19X6, are available; accordingly, the procedures carried out by us with respect to changes in financial statement items after May 31, 19X6, have, of necessity, been even more limited than those with respect to the periods referred to in 1*a* and 1*b*. We have inquired of certain officials of the company who have responsibility for financial and accounting matters whether (i) at June 25, 19X6, there was any change in the capital stock, increase in long-term debt, or any decreases in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown on the March 31, 19X6, unaudited condensed consolidated balance sheet included in the offering circular or (ii) for the period from April 1, 19X6, to June 25, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income.

Those officials referred to above stated that (i) at June 25, 19X6, there was no change in the capital stock, no increase in long-term debt, and no decreases in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown on the March 31, 19X6, unaudited condensed consolidated balance sheet, and (ii) there were no decreases for the period from April 1, 19X6, to June 25, 19X6, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total

or per-share amounts of income before extraordinary items or of net income.

2. At your request, we have read the following items in the offering circular on the indicated pages.[25]

Item	*Page*	*Description*
a	13	"History and Business—Sales and Marketing." The table following the first paragraph.
b	22	"Executive Compensation—19X5 Compensation."
c	33	"Selected Financial Data."[26]

3. Our audits of the consolidated financial statements for the periods referred to in the introductory paragraph of this letter comprised audit tests and procedures deemed necessary for the purpose of expressing an opinion on such financial statements taken as a whole. For none of the periods referred to therein, nor for any other period, did we perform audit tests for the purpose of expressing an opinion on individual balances of accounts or summaries of selected transactions such as those enumerated above, and, accordingly, we express no opinion thereon.

4. However, at your request, we have performed the following additional procedures, which were applied as indicated with respect to the items enumerated above.

Item in 2 — *Procedures and Findings*

a We compare the amounts of military sales, commercial sales, and total sales shown in the registration statement with the balances in the appropriate accounts in the company's accounting records for the respective fiscal years and for the unaudited interim periods and found them to be in agreement. We proved the arithmetic accuracy of the percentages of such amounts of military sales and commercial sales to total sales for the respective fiscal years and for the unaudited interim periods. We compared such computed percentages with the corresponding percentages appearing in the registration statement and found them to be in agreement.

b We compared the dollar amounts of compensation (salary, bonus, and other compensation) for each individual listed in the table "Annual Compensation" with the corresponding amounts shown by the individual employee earnings records for the year 19X5 and found them to be in agreement. We compared the dollar amounts shown under the heading of "Long-Term Compensation" on page 24 for each listed

[25] In some cases it may be considered desirable to combine in one paragraph the substance of paragraphs 2 and 4. This may be done by expanding the identification of terms in paragraph 4 to provide the identification information contained in paragraph 2. In such cases the introductory sentences in paragraphs 2 and 4 and the text of paragraph 3 might be combined as follows: "At your request, we have also read the following information and have performed the additional procedures stated below with respect to such information. Our audit of the consolidated financial statements...." [Footnote added, effective for letters issued pursuant to paragraph .09 of this section after April 30, 1996, by Statement on Auditing Standards No. 76.]

[26] See footnote 10 of the Appendix. [Footnote added, effective for letters issued pursuant to paragraph .09 of this section after April 30, 1996, by Statement on Auditing Standards No. 76.]

individual and the aggregate amounts for executive officers with corresponding amounts shown in an analysis prepared by the company and found such amounts to be in agreement.

c We compared the amounts of net sales, income from continuing operations, income from continuing operations per common share, and cash dividends declared per common share for the years ended December 31, 19X5, 19X4, and 19X3, with the respective amounts in the consolidated financial statements on pages 27 and 28 and the amounts for the years ended December 31, 19X2, and 19X1, with the respective amounts in the consolidated financial statements included in the company's annual reports to stockholders for 19X2 and 19X1 and found them to be in agreement.

We compared the amounts of total assets, long-term obligations, and redeemable preferred stock at December 31, 19X5 and 19X4, with the respective amounts in the consolidated financial statements on pages 27 and 28 and the amounts at December 31, 19X3, and 19X2, and 19X1 with the corresponding amounts in the consolidated financial statements included in the company's annual reports to stockholders for 19X3, 19X2, and 19X1 and found them to be in agreement.

5. It should be understood that we have no responsibility for establishing (and did not establish) the scope and nature of the procedures enumerated in paragraphs 1 through 4 above; rather, the procedures enumerated therein are those the requesting party asked us to perform. Accordingly, we make no representations regarding questions of legal interpretation[27] or regarding the sufficiency for your purposes of the procedures enumerated in the preceding paragraphs; also, such procedures would not necessarily reveal any material misstatement of the amounts or percentages listed above as set forth in the offering circular. Further, we have addressed ourselves solely to the foregoing data and make no representations regarding the adequacy of disclosures or whether any material facts have been omitted. This letter relates only to the financial statement items specified above and does not extend to any financial statement of the company taken as a whole.

6. The foregoing procedures do not constitute an audit conducted in accordance with generally accepted auditing standards. Had we performed additional procedures or had we conducted an audit or a review of the company's March 31, April 30, or May 31, 19X6 and 19X5, condensed consolidated financial statements in accordance with standards established by the American Institute of Certified Public Accountants, other matters might have come to our attention that would have been reported to you.

7. These procedures should not be taken to supplant any additional inquiries or procedures that you would undertake in your consideration of the proposed offering.

8. This letter is solely for your information and to assist you in your inquiries in connection with the offering of the securities covered by the offering circular, and it is not to be used, circulated, quoted, or otherwise referred to for any other purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the

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[27] See footnote 7 to paragraph .09. [Footnote added, effective for letters issued pursuant to paragraph .09 of this section after April 30, 1996, by Statement on Auditing Standards No. 76.]

offering document or any other document, except that reference may be made to it in any list of closing documents pertaining to the offering of the securities covered by the offering document.

9. We have no responsibility to update this letter for events and circumstances occurring after June 25, 19X6.

Example R: Comfort Letter That Includes Reference to Examination of Annual MD&A and Review of Interim MD&A

19. This example assumes the following circumstances.[28] The prospectus (part I of the registration statement) includes audited consolidated balance sheets as of December 31, 19X5 and 19X4, and audited consolidated statements of income, retained earnings (stockholders' equity), and cash flows for each of the three years in the period ended December 31, 19X5. Part I also includes an unaudited condensed consolidated balance sheet as of March 31, 19X6, and unaudited condensed consolidated statements of income, retained earnings (stockholders' equity), and cash flows for the three-month periods ended March 31, 19X6 and 19X5. Part II of the registration statement includes audited consolidated financial statement schedules for the three years ended December 31, 19X5. The accountants have examined the company's management's discussion and analysis (MD&A) for the year ended December 31, 19X5, in accordance with AT section 701; the accountants have also performed reviews of the company's unaudited condensed consolidated financial statements, referred to above, in accordance with section 722, and the company's MD&A for the three-month period ended March 31, 19X6, in accordance with AT section 701. The accountant's reports on the examination and review of MD&A have been previously issued, but not distributed publicly; none of these reports is included in the registration statement. The cutoff date is June 23, 19X6, and the letter is dated June 28, 19X6. The effective date is June 28, 19X6.

Each of the comments in the letter is in response to a requirement of the underwriting agreement. For purposes of example R, the income statement items of the current interim period are to be compared with those of the corresponding period of the preceding year.

June 28, 19X6

[*Addressee*]

Dear Sirs:

We have audited the consolidated balance sheets of The Blank Company, Inc. (the company) and subsidiaries as of December 31, 19X5 and 19X4, and the consolidated statements of income, retained earnings (stockholders' equity), and cash flows for each of the three years in the period ended December 31, 19X5, and the related financial statement schedules, all included in the registration statement (no. 33-00000) on Form S-1 filed by the company under the Securities Act of 1933 (the Act); our reports with respect thereto are also included in that registration statement. The registration statement, as amended on June 28, 19X6, is herein referred to as the registration statement. Also, we have examined[29] the company's Management's Discussion and Analysis for the year ended December 31, 19X5, included in the registration statement, as indicated in our report dated March 28, 19X6; our report with respect thereto is attached.[30] We have also reviewed the unaudited condensed consolidated financial statements

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[28] The example includes financial statements required by SEC regulations to be included in the filing. If additional financial information is covered by the comfort letter, appropriate modifications should be made. [Footnote added, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86.]

[29] If the accountant has performed a review of the company's annual MD&A, the opening paragraph of the comfort letter should be revised accordingly. [Footnote added, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86.]

[30] The accountant has elected to attach the previously issued reports to the comfort letter (see paragraph .29). [Footnote added, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86.]

as of March 31, 19X6 and 19X5, and for the three-month periods then ended, included in the registration statement, as indicated in our report dated May 15, 19X6, and have also reviewed the company's Management's Discussion and Analysis for the three-month period ended March 31, 19X6, included in the registration statement, as indicated in our report dated May 15, 19X6; our reports with respect thereto are attached.[31]

In connection with the registration statement—

1. We are independent certified public accountants with respect to the company within the meaning of the Act and the applicable rules and regulations thereunder adopted by the SEC.

2. In our opinion [*include the phrase "except as disclosed in the registration statement," if applicable*], the consolidated financial statements and financial statement schedules audited by us and included in the registration statement comply as to form in all material respects with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC.

3. We have not audited any financial statements of the company as of any date or for any period subsequent to December 31, 19X5; although we have conducted an audit for the year ended December 31, 19X5, the purpose (and therefore the scope) of the audit was to enable us to express our opinion on the consolidated financial statements as of December 31, 19X5, and for the year then ended, but not on the financial statements for any interim period within that year. Therefore, we are unable to and do not express any opinion on the unaudited condensed consolidated balance sheet as of March 31, 19X6, and the unaudited condensed consolidated statements of income, retained earnings (stockholders' equity), and cash flows for the three-month periods ended March 1, 19X6 and 19X5, included in the registration statement, or on the financial position, results of operations, or cash flows as of any date or for any period subsequent to December 31, 19X5.

4. We have not examined any management's discussion and analysis of the company as of or for any period subsequent to December 31, 19X5; although we have made an examination of the company's Management's Discussion and Analysis for the year ended December 31, 19X5, included in the company's registration statement, the purpose (and therefore the scope) of the examination was to enable us to express our opinion on such Management's Discussion and Analysis, but not on the management's discussion and analysis for any interim period within that year. Therefore, we are unable to and do not express any opinion on the Management's Discussion and Analysis for the three-month period ended March 31, 19X6, included in the registration statement, or for any period subsequent to March 31, 19X6.

5. For purposes of this letter we have read the 19X6 minutes of meetings of the stockholders, the board of directors, and [*include other appropriate committees, if any*] of the company and its subsidiaries as set forth in the minute books at June 23, 19X6, officials of the company having advised us that the minutes of all such meetings[32] through that date were set forth therein; we have carried out other procedures to June 23, 19X6, as follows (our work did not extend to the period from June 24, 19X6, to June 28, 19X6, inclusive):

a. With respect to the three-month periods ended March 31, 19X6 and 19X5, we have inquired of certain officials of the

[31] See footnote 30 of the Appendix. [Footnote added, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86.]

[32] See footnote 3 of the Appendix. [Footnote added, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86.]

company who have responsibility for financial and accounting matters whether the unaudited condensed consolidated balance sheet as of March 31, 19X6, and the unaudited condensed consolidated statements of income, retained earnings (stockholders' equity), and cash flows for the three-month periods ended March 31, 19X6 and 19X5, included in the registration statement, comply as to form in all material respects with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC.

b. With respect to the period from April 1, 19X6, to May 31, 19X6, we have—

(i) Read the unaudited consolidated financial statements[33] of the company and subsidiaries for April and May of both 19X5 and 19X6 furnished to us by the company, officials of the company having advised us that no such financial statements as of any date or for any period subsequent to May 31, 19X6, were available.

(ii) Inquired of certain officials of the company who have responsibility for financial and accounting matters whether the unaudited consolidated financial statements referred to in item b(i) are stated on a basis substantially consistent with that of the audited consolidated financial statements included in the registration statement.

The foregoing procedures do not constitute an audit of financial statements conducted in accordance with generally accepted auditing standards. Also, they would not necessarily reveal matters of significance with respect to the comments in the following paragraph. Accordingly, we make no representations regarding the sufficiency of the foregoing procedures for your purposes.

6. Nothing came to our attention as a result of the foregoing procedures, however, that caused us[34] to believe that—

a. The unaudited condensed consolidated financial statements described in item 5*a* do not comply as to form in all material respects with the applicable accounting requirements of the Act and the related rules and regulations adopted by the SEC.

b.

(i) At May 31, 19X6, there was any change in the capital stock, increase in long-term debt, or decrease in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown in the March 31, 19X6, unaudited condensed consolidated balance sheet included in the registration statement, or

(ii) For the period from April 1, 19X6, to May 31, 19X6, there were any decreases, as compared to the corresponding period in the preceding year, in consoli-

[33] See footnote 4 of the Appendix. [Footnote added, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86.]

[34] See footnote 5 of the Appendix. [Footnote added, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86.]

dated net sales or in the total or per-share amounts of income before extraordinary items or of net income, except in all instances for changes, increases, or decreases that the registration statement discloses have occurred or may occur.

7. As mentioned in item 5*b*, company officials have advised us that no consolidated financial statements as of any date or for any period subsequent to May 31, 19X6, are available; accordingly, the procedures carried out by us with respect to changes in financial statement items after May 31, 19X6, have, of necessity, been even more limited than those with respect to the periods referred to in item 5. We have inquired of certain officials of the company who have responsibility for financial and accounting matters whether (*a*) at June 23, 19X6, there was any change in the capital stock, increase in long-term debt or any decreases in consolidated net current assets or stockholders' equity of the consolidated companies as compared with amounts shown on the March 31, 19X6, unaudited condensed consolidated balance sheet included in the registration statement or (*b*) for the period from April 1, 19X6, to June 23, 19X6, there were any decreases, as compared with the corresponding period in the preceding year, in consolidated net sales or in the total or per-share amounts of income before extraordinary items or of net income. On the basis of these inquiries and our reading of the minutes as described in item 5, nothing came to our attention that caused us to believe that there was any such change, increase, or decrease, except in all instances for changes, increases, or decreases that the registration statement discloses have occurred or may occur.

8. This letter is solely for the information of the addressees and to assist the underwriters in conducting and documenting their investigation of the affairs of the company in connection with the offering of the securities covered by the registration statement, and it is not to be used, circulated, quoted, or otherwise referred to within or without the underwriting group for any purpose, including but not limited to the registration, purchase, or sale of securities, nor is it to be filed with or referred to in whole or in part in the registration statement or any other document, except that reference may be made to it in the underwriting agreement or in any list of closing documents pertaining to the offering of the securities covered by the registration statement.

[Paragraph renumbered and amended, effective for letters issued pursuant to paragraph .09 of this section after April 30, 1996, by the issuance of Statement on Auditing Standards No. 76. As amended, effective for comfort letters issued on or after June 30, 1998, by Statement on Auditing Standards No. 86. Revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

AU Section 9634

Letters for Underwriters and Certain Other Requesting Parties: Auditing Interpretations of Section 634

1. Letters to Directors Relating to Annual Reports on Form 10-K[*]

.01 *Question*—Annual reports to the Securities and Exchange Commission (SEC) on Form 10-K must be signed by at least a majority of the registrant's board of directors. In reviewing the Form 10-K, directors may seek the involvement of the registrant's independent auditors and other professionals.

.02 What types of services could the auditor perform at the request of the board of directors in connection with the Form 10-K? For example, is it permissible for the auditor to comment on compliance of the registrant's Form 10-K with the requirements of the various SEC rules and regulations?[1]

.03 *Interpretation*—The auditor can express an opinion to the board of directors on whether the financial statements and financial statement schedules audited comply as to form with the applicable accounting requirements of the Securities Exchange Act of 1934 and the related rules and regulations thereunder adopted by the SEC (see section 634.33).[2]

.04 The auditor may affirm to the board of directors that under generally accepted auditing standards the auditor is required to read the information in addition to audited financial statements contained in the Form 10-K, for the purpose of considering whether such information may be materially inconsistent with information appearing in the financial statements (see section 550). However, the report to the board of directors should state that the auditor has no obligation to perform any procedures to corroborate such information.

.05 In addition, the auditor could perform, at the request of the board of directors, specified procedures and report the results of those procedures concerning various information contained in the Form 10-K such as tables, statistics and other financial information. There should be a clear understanding with the board as to the nature, extent and limitations of the procedures to be performed and as to the kind of report to be issued. Although the guidance provided in section 634 is intended primarily for auditors issuing a letter to underwriters and certain other requesting parties in connection with an offering of securities, the guidance in section 634.54-.60 would also be applicable when the auditor is asked to furnish a letter to the board of directors

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[*] [Footnote deleted June 1993, by the issuance of Statement on Auditing Standards No. 72.]

[1] [Footnote deleted June 1993, by the issuance of Statement on Auditing Standards No. 72.]

[2] The auditor should not provide any assurance on compliance with the provisions of the Securities Exchange Act of 1934 regarding controls. See the guidance provided in AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*, paragraph .82.[§]

[§] AT section 501 has been superseded by PCAOB Release No. 2004-008. The PCAOB has not yet made conforming changes that may be necessary.

in connection with the filing of Form 10-K under the Securities Exchange Act of 1934.[3] The types of information on which auditors may comment are described in section 634.55. The auditor should comment only on that information if the criteria in section 634.55 and .57 have been met. The comments should be made in the form of description of procedures performed and findings obtained, ordinarily expressed in terms of agreement between items compared.

.06 Certain financial information in Form 10-K is included because of specific requirements of Regulation S-K. The auditor may comment as to whether this information is in conformity with the disclosure requirements of Regulation S-K if the conditions in section 634.57 are met. Section 634.57 identifies the disclosure requirements of Regulation S-K that generally meet those conditions. The auditor is limited to giving negative assurance, since this information is not given in the form of financial statements and generally has not been audited by the accountants. (See section 634.57.)

.07 The auditor should not comment on matters that are primarily subjective or judgmental in nature such as those included in Item 7 of Form 10-K, "Management's Discussion and Analysis of Financial Condition and Results of Operations." For example, changes between periods in gross profit ratios may be caused by factors that are not necessarily within the expertise of auditors. However, the auditor can comment on specific changes in comparative amounts that are included in management's discussion if the amounts used to compute such changes are obtained from the financial statements or accounting records as discussed in section 634.55, but cannot comment with respect to the appropriateness of the explanations.

.08 There are no criteria by which to measure the sufficiency of the procedures performed by the accountants for the directors' purposes. Ordinarily the auditor should discuss with the directors or the audit committee the procedures to be performed and may suggest procedures that might be meaningful in the circumstances. However, the auditor should clearly indicate to the board of directors that the auditor cannot make any representations as to whether the agreed-upon procedures are sufficient for the directors' purposes.

.09 It should not ordinarily be necessary for the auditor to reaffirm the auditor's independence to the board of directors. If such a representation is requested, however, the auditor may include in the letter a statement similar to that described in section 634.31.

[Issue Date: April, 1981; Modified: May, 1981;
Revised: June, 1993; Revised: January, 2001.]

[2.] Negative Assurance on Unaudited Condensed Interim Financial Statements Attached to Comfort Letters

[.10–.12] [Deleted April, 1993 by Statement on Auditing Standards No. 72.]

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[3] Section 634.12 states in part: "Accountants will normally be willing to assist the underwriter but the assistance accountants can provide by way of comfort letters is subject to limitations. One limitation is that independent accountants can properly comment in their professional capacity only on matters to which his professional expertise is substantially relevant."

3. Commenting in a Comfort Letter on Quantitative Disclosures About Market Risk Made in Accordance With Item 305 of Regulation S-K

.13 *Introduction*—Regulation S-K, Item 305, *Quantitative and Qualitative Disclosures About Market Risk*, requires certain quantitative and qualitative disclosures with respect to—

a. Derivative financial instruments, generally as defined in Financial Accounting Standards Board (FASB) Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* [AC section F25],

b. Other financial instruments, generally as defined in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* [AC section F25], and

c. Derivative commodity instruments, such as commodity futures, forwards, and swaps that are permitted by contract or custom to be settled in cash.

Collectively these instruments are referred to as cmarket-risk-sensitive instruments.d

.14 In addition to qualitative (i.e., descriptive) disclosures, Item 305 requires quantitative disclosures that may be presented in the form of a tabular presentation, sensitivity analysis, or value-at-risk disclosures. Disclosures generally include a combination of historical and fair value data and the hypothetical effects on such data of assumed changes in interest rates, foreign currency exchange rates, commodity prices and other relevant market rates. The quantitative and qualitative information required by Item 305 should be disclosed outside the financial statements and related notes thereto.

.15 *Question*—May an accountant provide positive or negative assurance on conformity with Item 305 of Regulation S-K?

.16 *Interpretation*—Section 634, *Letters for Underwriters and Certain Other Requesting Parties*, paragraph .57, states that accountants may not give positive assurance on conformity of information with the disclosure requirements of Regulation S-K since this information is not in the form of financial statements and generally has not been audited by the accountants. Accountants may provide negative assurance on conformity with Regulation S-K only if the following conditions are met:

a. The information is derived from the accounting records subject to the entity's controls over financial reporting, or has been derived directly from such accounting records by analysis or computation.

b. This information is capable of evaluation against reasonable criteria that have been established by the SEC.

Although some information needed to comply with Item 305 is derived from the accounting records, registrants must also provide a substantial amount of information that is not derived from accounting records subject to the entity's controls over financial reporting. As a result, accountants should not provide negative assurance on conformity with Item 305 of Regulation S-K.

.17 *Question*—May an accountant otherwise provide comments in a comfort letter on items disclosed by registrants in accordance with Item 305 of Regulation S-K?

.18 *Interpretation*—Section 634.55 states that accountants should comment only with respect to information—

a. That is expressed in dollars (or percentages derived from such dollar amounts) and that has been obtained from accounting records that are subject to the entity's controls over financial reporting or

b. That has been derived directly from such accounting records by analysis or computation.

As a result, accountants should not comment on the Item 305 qualitative disclosures.

.19 The three alternative forms of quantitative disclosures under Item 305 reflect hypothetical effects on market-risk-sensitive instruments and result in differing presentations. The forward-looking information used to prepare these presentations may be substantially removed from the accounting records that are subject to the entity's controls over financial reporting. Further, section 634.55 also states that cthe accountants should not comment on matters merely because they happen to be present and are capable of reading, counting, measuring, or performing other functions that might be applicable.d Accordingly, an accountant's ability to comment on these disclosures is largely dependent upon the degree to which the forward-looking information used to prepare these disclosures is linked to such accounting records.

.20 The tabular presentation includes the fair values of market-risk-sensitive instruments and contract terms to determine the future cash flows from those instruments that are categorized by expected maturity dates. This approach may require the use of yield curves and implied forward rates to determine expected maturity dates, as well as assumptions regarding prepayments and weighted average interest rates.

.21 The term *sensitivity analysis* describes a general class of models that are designed to assess the risk of loss in market-risk-sensitive instruments, based upon hypothetical changes in market rates or prices. Sensitivity analysis does not refer to any one, specific model and may include duration analysis or other csensitivityd measures. The disclosures are dependent upon assumptions about theoretical future market conditions and, therefore, are not derived from the accounting records.

.22 The term *value at risk* describes a general class of models that provide a probabilistic assessment of the risk of loss in market-risk-sensitive instruments over a selected period of time, with a selected likelihood of occurrences based upon selected confidence intervals. Value-at-risk disclosures are extremely aggregated and, in addition to the assumptions made for sensitivity analyses, may include additional assumptions regarding correlation between asset classes and future market volatilities. As a result, these disclosures are not derived from the accounting records.

.23 Of the three disclosure alternatives, the tabular presentation contains the most limited number of assumptions and least complex mathematical calculations. Furthermore, certain information, such as contractual terms, included in a tabular presentation is derived from the accounting records. Accordingly, accountants may perform limited procedures related to tabular presentations to the extent that such information is derived from the accounting records.

.24 The modeling techniques and underlying assumptions utilized for sensitivity analysis and value-at-risk disclosures generally will be highly complex. The resultant disclosures may be substantially different from the

basic historical financial input derived directly from the accounting records. Due to the hypothetical and forward-looking nature of these disclosures and the potentially limited usefulness of any procedures that may be performed, accountants should not agree to make any comments or perform any procedures related to sensitivity analysis or value-at-risk disclosures.

.25 When performing procedures related to tabular presentation disclosures, the accountant will need to consider whether the entity's documentation of its contractual positions in derivatives, commodities and other financial instruments is subject to the entity's controls over financial reporting and whether it provides a complete record of the entity's market-risk-sensitive instruments. In addition, the accountant should disclaim as to the reasonableness of the assumptions underlying the disclosures.

.26 Item 305 requires registrants to stratify financial instruments according to market risk category, i.e., interest rate risk, foreign exchange risk, and equity price risk. Item 305 stipulates that, if an instrument is at risk in more than one category, the instrument should be included in the disclosures for each applicable category. In reporting findings from agreed-upon procedures relating to market risk categories, the accountant should not provide any findings that the company's stratifications are complete or comply as to form with Item 305 requirements and should disclaim with respect to the company's determination of market risk categories.

.27 Item 305 encourages registrants to provide quantitative and qualitative information about market risk in terms of, among other things, the magnitude of actual past market movements and estimates of possible near-term market movements. Accountants should not agree to perform any procedures related to such market data.

.28 The accountant should establish a clear understanding with the underwriter as to the limitations of the procedures to be performed with respect to the market risk disclosures. Further, accountants should consider the need to utilize a specialist in performing procedures related to those disclosures.

.29 The following examples, based upon Example H of section 634.64, provide very simplified procedures, findings and limitations related to Item 305 tabular presentation disclosures. In practice, the procedures generally will be substantially more complex.

Symbol	Procedures and Findings
√	Compared with a schedule prepared by the Company from its accounting records. We (*a*) compared the amounts on the schedule to corresponding amounts appearing in the accounting records and found such amounts to be in agreement and (*b*) determined that the schedule was mathematically correct. However, we make no comment as to the appropriateness or completeness of the Company's classification of its market-risk-sensitive instruments into market risk categories, nor as to its determination of the expected maturity dates or amounts. (Note: This is an example of procedures related to tabular presentations of face amounts, carrying amounts, fair values and notional amounts which stratify such amounts as to interest rate risk.)

Symbol	Procedures and Findings
⊗	Compared with a schedule prepared by the Company from its accounting records to calculate weighted average fixed interest rates and weighted average fixed pay and receive rates, and found such percentages to be in agreement. We (*a*) compared the amounts on the schedule to corresponding amounts appearing in the accounting records and found such amounts to be in agreement and (*b*) determined that the schedule was mathematically correct. However, we make no comment as to the appropriateness of the Company's methodology in calculating weighted average fixed rates. (Note: It may be necessary to provide a more complete description of the procedures performed in other circumstances.) We make no comment as to the appropriateness or completeness of the Company's determination of the Regulation S-K requirements for quantitative and qualitative disclosures about market risks or with respect to the reasonableness of the assumptions underlying the disclosures.

[*The following is an extract from a registration statement that illustrates how an accountant can document procedures performed on a tabular presentation of market risk disclosures made in accordance with Item 305 of Regulation S-K.*]

INTEREST RATE SENSITIVITY

The table below provides information about the Company's derivative financial instruments and other financial instruments that are sensitive to changes in interest rates, including interest rate swaps and debt obligations. For debt obligations, the table presents principal cash flows and related weighted average interest rates by expected maturity dates. For interest rate swaps, the table presents notional amounts and weighted average interest rates by expected maturity dates. Notional amounts are used to calculate the contractual payments to be exchanged under the contract. Weighted average variable rates are based on implied forward rates in the yield curve at the reporting date. The information is presented in U.S. dollar equivalents, which is the Company's reporting currency. The instrument's actual cash flows are denominated in both U.S. dollars ($US) and German deutschmarks (DM), as indicated in parentheses.

	Expected maturity dates						
	19X2[4]	*19X3*[4]	*19X4*[4]	*19X5*[4]	*There-after*[4]	*Total*	*Fair Value*
Liabilities							
Long-Term Debt:			(*$US equivalent in millions*)				
Fixed Rate ($US)	$XXX	$XXX	$XXX	$XXX	$XXX	$XXX√	$XXX√
Average interest rate	XX%	XX%	XX%	XX%	XX%	XX%⊗	
Fixed Rate (DM)	XXX	XXX	XXX	XXX	XXX	XXX√	XXX√
Average interest rate	XX%	XX%	XX%	XX%	XX%	XX%⊗	
Variable Rate ($US)	XXX	XXX	XXX	XXX	XXX	XXX√	XXX√
Average interest rate	XX%	XX%	XX%	XX%	XX%	XX%[4]	
Interest Rate Derivatives			*($US equivalent in millions)*				
Interest Rate Swaps:							
Variable to Fixed ($US)	*$XXX*	*$XXX*	*$XXX*	*$XXX*	*$XXX*	*$XXX√*	*$XXX√*
Average pay rate-fixed	*XX%*	*XX%*	*XX%*	*XX%*	*XX%*	*XX% ⊗*	
Average receive rate-variable	*XX%*	*XX%*	*XX%*	*XX%*	*XX%*	*XX%*[4]	
Fixed to Variable ($US)	*XXX*	*XXX*	*XXX*	*XXX*	*XXX*	*XXX√*	*XXX√*
Average pay rate-variable	*XX%*	*XX%*	*XX%*	*XX%*	*XX%*	*XX%*[4]	
Average receive rate-fixed	*XX%*	*XX%*	*XX%*	*XX%*	*XX%*	*XX% ⊗*	

[Issue Date: August, 1998.]

[4] No findings should be expressed on amounts in these columns because these disclosures include either management's expectations of future cash flows or the use of implied forward rates applied to such expected cash flows. Accordingly, such information does not meet the criteria of section 634.55.

AU Section 9642

Reporting on Internal Accounting Control: Auditing Interpretations of SAS No. 30

Many of the interpretations in this section were based on the concepts in Statement on Auditing Standards (SAS) No. 30, *Reporting on Internal Accounting Control*. SAS No. 30 was superseded in May 1993 by the issuance of Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Over Financial Reporting*. Subsequently, SSAE No. 2 was superseded by SSAE No. 10, Attestation Standards: Revision and Recodification, which was issued in January 2001. The AICPA's Auditing Standards Board decided at its October 1993 meeting to delete these interpretations. Notes have been included below to indicate where current guidance may be found in AICPA literature.

[1.] Pre-Award Surveys[*]

[.01–.03] [Deleted October 1993.] (See the guidance provided in paragraphs .01–.08 of attest interpretation No. 1 of SSAE No. 10, chapter 5 (AT section 9501.01–.08). [Revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

[2.] Award Survey Made in Conjunction With an Audit

[.04–.05] [Deleted October 1993.] (See the guidance provided in paragraphs .01–.08 of attest interpretation No. 1 of SSAE No. 10, chapter 5 (AT section 9501.01–.08). [Revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

[3.] Reporting on Matters Not Covered by Government-Established Criteria

[.06–.07] [Deleted October 1993. Revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

[4.] Limited Scope

[.08–.09] [Deleted October 1993.] (See the guidance provided in SSAE No. 10, chapter 5, paragraph 5.69 (AT section 501.69).) [Revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

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[*] [Footnote deleted, October 1993.]

[5.] Compliance With the Foreign Corrupt Practices Act of 1977

[.10–.13] [Deleted October 1993.] (See the guidance provided in SSAE No. 10, chapter 5, paragraph 5.82 (AT section 501.82).) [Revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

[6.] Reports on Internal Accounting Control of Trust Departments of Banks

[.14–.17] [Deleted October 1993.] (See the guidance provided in SSAE No. 10, chapter 5, paragraph 5.69 (AT section 501.69).) [Revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

[7.] Report Required by U.S. General Accounting Office[1-7]

[.18–.25] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

[8.] Form of Report on Internal Accounting Control Based Solely on a Study and Evaluation Made as Part of an Audit[8-10]

[.26–.32] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

[9.] Reporting on Internal Accounting Control Based Solely on an Audit When a Minimum Study and Evaluation Is Made

[.33–.34] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

[10.] Report Required by U.S. General Accounting Office Based on a Financial and Compliance Audit When a Study and Evaluation Does Not Extend Beyond the Preliminary Review Phase[11-15]

[.35–.36] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

[1-7] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

[8-10] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

[11-15] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

[11.] Restricted Purpose Report Required by Law to Be Made Available to the Public[16]

[.37–.38] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

[12.] Reporting on Internal Accounting Control "Compliance With the Currency and Foreign Transactions Reporting Act"[*]

[.39–.41] [Deleted October 1993.]

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[16] [Superseded by Statement on Auditing Standards No. 60, effective for audits of financial statements for periods beginning on or after January 1, 1989.] (See section 325.)

[*] [Footnote deleted, October 1993.]

AU Section 700
SPECIAL TOPICS

TABLE OF CONTENTS

AU Section 711*

Filings Under Federal Securities Statutes

Source: SAS No. 37; Auditing Standard No. 5; Auditing Standard No. 16.

See section 9711 for interpretations of this section.

Issue date, unless otherwise indicated: April, 1981.

.01 As in the case of financial statements used for other purposes, management has the responsibility for the financial representations contained in documents filed under the federal securities statutes. In this connection the Securities and Exchange Commission has said:

> The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon the accounting.[1]

.02 When an independent accountant's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes, the accountant's responsibility, generally, is in substance no different from that involved in other types of reporting. However, the nature and extent of this responsibility are specified in some detail in these statutes and in the related rules and regulations. For example, section 11(*a*) of the Securities Act of 1933, as amended, imposes responsibility for false or misleading statements in an effective registration statement, or for omissions that render statements made in such a document misleading, on every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, report, or valuation, which purports to have been prepared or certified by him.

[The following note is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]

> Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs C16–C17 of Appendix C, *Special Reporting Situations*, of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, which provide direction when an auditor's report on internal control over financial reporting is included or incorporated by reference in filings under federal securities statutes.

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* ***Note:*** This section supersedes Statement on Auditing Standards No. 1, section 710, *Filings Under Federal Securities Statutes*. The changes provide guidance for the accountant whose report based on a review of interim financial information is presented, or incorporated by reference, in a filing under the Securities Act of 1933.

[1] 4 S.E.C. 721 (1939).

.03 Section 11 also makes specific mention of the independent accountant's responsibility as an expert when his report is included in a registration statement filed under that act.[2] Section 11(*b*) states, in part, that no person shall be liable as provided therein if that person sustains the burden of proof that

> as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert....

Section 11 further provides that, in determining what constitutes reasonable investigation and reasonable ground to believe, "the standard of reasonableness shall be that required of a prudent man in the management of his own property."

.04 This discussion of the independent accountant's responsibilities in connection with filings under the federal securities statutes is not intended to offer legal interpretations and is based on an understanding of the meaning of the statutes as they relate to accounting principles and auditing standards and procedures. The discussion is subject to any judicial interpretations that may be issued.

.05 Because a registration statement under the Securities Act of 1933 speaks as of its effective date, the independent accountant whose report is included in such a registration statement has a statutory responsibility that is determined in the light of the circumstances on that date. This aspect of responsibility is peculiar to reports used for this purpose (see paragraphs .10 through .12).

.06 Under rules of the Securities and Exchange Commission, an independent accountant's report based on a review of interim financial information is not a report by the accountant within the meaning of section 11. Thus, the accountant does not have a similar statutory responsibility for such reports as of the effective date of the registration statement (see paragraph .13).

.07 The other federal securities statutes, while not containing so detailed an exposition, do impose responsibility, under certain conditions, on persons making false or misleading statements with respect to any material fact in applications, reports, or other documents filed under the statute.

.08 In filings under the Securities Act of 1933, a statement frequently is made in the prospectus (sometimes included in a section of the prospectus called the *experts section*) that certain information is included in the registration statement in reliance upon the report of certain named experts. The independent accountant should read the relevant section of the prospectus to make sure that his name is not being used in a way that indicates that his responsibility is greater than he intends. The experts section should be so worded that there is no implication that the financial statements have been prepared by the independent accountant or that they are not the direct representations of management.

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[2] Under rules of the Securities and Exchange Commission, a report based on a review of interim financial information is not a report by the accountant under section 11 (see paragraph .06).

.09 The Securities and Exchange Commission requires that, when an independent accountant's report based on a review of interim financial information is presented or incorporated by reference in a registration statement, a prospectus that includes a statement about the independent accountant's involvement should clarify that his review report is not a "report" or "part" of the registration statement within the meaning of sections 7 and 11 of the Securities Act of 1933. In this respect, wording such as the following in a prospectus would ordinarily be considered a satisfactory description for the accountant's purposes of the status of his review report that was included in a Form 10-Q filing that was later incorporated by reference in a registration statement.[3]

Independent Public Accountants

> The consolidated balance sheets as of December 31, 19X2 and 19X1, and the consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X2, incorporated by reference in this prospectus, have been included herein in reliance on the report of _____ independent public accountants, given on the authority of that firm as experts in auditing and accounting.
>
> With respect to the unaudited interim financial information for the periods ended March 31, 19X3 and 19X2, incorporated by reference in this prospectus, the independent public accountants have reported that they have applied limited procedures in accordance with professional standards for a review of such information. However, their separate report included in the company's quarterly report on Form 10-Q for the quarter ended March 31, 19X3, and incorporated by reference herein, states that they did not audit and they do not express an opinion on that interim financial information. Accordingly, the degree of reliance on their report on such information should be restricted in light of the limited nature of the review procedures applied. The accountants are not subject to the liability provisions of section 11 of the Securities Act of 1933 for their report on the unaudited interim financial information because that report is not a "report" or a "part" of the registration statement prepared or certified by the accountants within the meaning of sections 7 and 11 of the act.

The independent accountant should also read other sections of the prospectus to make sure that his name is not being used in a way that indicates that his responsibility is greater than he intends.

Subsequent Events Procedures in 1933 Act Filings

.10 *[The following paragraph is effective for audits of fiscal years ending on or after November 15, 2007. See PCAOB Release 2007-005.]*

To sustain the burden of proof that he has made a "reasonable investigation" (see paragraph .03), as required under the Securities Act of 1933, an auditor should extend his procedures with respect to subsequent events from the date of his audit report up to the effective date or as close thereto as is reasonable and practicable in the circumstances. In this connection, he should arrange with his client to be kept advised of the progress of the registration proceedings so that his review of subsequent events can be completed by the effective date. The likelihood that the auditor will discover subsequent events necessarily decreases following the date of the auditor's report, and, as a practical matter,

[3] A similar description of the status of the accountant's report would also ordinarily be satisfactory for the accountant's purposes when the accountant's review report is presented in the registration statement rather than incorporated by reference. In that case, the description in the prospectus would specifically refer to that report in the registration statement.

after that time the independent auditor may rely, for the most part, on inquiries of responsible officials and employees. In addition to performing the procedures outlined in section 560.12, at or near the effective date, the auditor generally should

a. Read the entire prospectus and other pertinent portions of the registration statement.

b. Inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters (limited where appropriate to major locations) about whether any events have occurred, other than those reflected or disclosed in the registration statement, that, in the officers' or other executives' opinion, have a material effect on the audited financial statements included therein or that should be disclosed in order to keep those statements from being misleading.

.11 A registration statement filed with the Securities and Exchange Commission may contain the reports of two or more independent auditors on their audits of the financial statements for different periods. An auditor who has audited the financial statements for prior periods but has not audited the financial statements for the most recent audited period included in the registration statement has a responsibility relating to events subsequent to the date of the prior-period financial statements, and extending to the effective date, that bear materially on the prior-period financial statements on which he reported. Generally, he should

a. Read pertinent portions of the prospectus and of the registration statement.

b. Obtain a letter of representation from the successor independent auditor regarding whether his audit (including his procedures with respect to subsequent events) revealed any matters that, in his opinion, might have a material effect on the financial statements reported on by the predecessor auditor or would require disclosure in the notes thereto.

The auditor should make inquiries and perform other procedures that he considers necessary to satisfy himself regarding the appropriateness of any adjustment or disclosure affecting the prior-period financial statements covered by his report (see section 508).

Response to Subsequent Events and Subsequently Discovered Facts

.12 If, subsequent to the date of his report on audited financial statements, the auditor (including a predecessor auditor) (*a*) discovers, in performing the procedures described in paragraphs .10 and .11 above, subsequent events that require adjustment or disclosure in the financial statements or (*b*) becomes aware that facts may have existed at the date of his report that might have affected his report had he then been aware of those facts, he should follow the guidance in sections 560 and 561. If the financial statements are appropriately adjusted or the required additional disclosure is made, the auditor should follow the guidance in sections 530.05 and 530.07 and .08, with respect to dating his report. If the client refuses to make appropriate adjustment or disclosure in the financial statements for a subsequent event or subsequently discovered facts, the auditor should follow the procedures in section 561.08 and .09. In such circumstances, the auditor should also consider, probably with the advice of his

legal counsel, withholding his consent to the use of his report on the audited financial statements in the registration statement.

.13 *[The following paragraph is effective for audits of fiscal years ending on or after December 15, 2012. See PCAOB Release 2012-004.]*

If an accountant concludes on the basis of facts known to him that unaudited financial statements or unaudited interim financial information presented or incorporated by reference in a registration statement are not in conformity with generally accepted accounting principles, he should insist on appropriate revision. Failing that,

a. If the accountant has reported on a review of such interim financial information and the subsequently discovered facts are such that they would have affected his report had they been known to him at the date of his report, he should refer to section 561, because certain provisions of that section may be relevant to his consideration of those matters (see section 722.46).

b. If the accountant has not reported on a review of the unaudited financial statements or interim financial information, he should modify his report on the audited financial statements to describe the departure from generally accepted accounting principles contained in the unaudited financial statements or interim financial information.

In either case, the accountant should communicate the matter to the audit committee and also consider withholding his consent to the use of his report on the audited financial statements in the registration statement. [Revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 100.]

AU Section 9711

Filings Under Federal Securities Statutes: Auditing Interpretations of Section 711

1. Subsequent Events Procedures for Shelf Registration Statements Updated after the Original Effective Date

.01 *Question*—Rule 415 of Regulation C under the Securities Act of 1933 (1933 Act) permits companies to register a designated amount of securities for continuous or delayed offerings by filing one "shelf" registration statement with the SEC. Under this rule, a registrant can register an amount of securities it reasonably expects to offer and sell within the next two years, generally without the later need to prepare and file a new prospectus and registration statement for each sale.

.02 A Rule 415 shelf registration statement can be updated after its original effective date by—

a. The filing of a post-effective amendment,

b. The incorporation by reference of subsequently filed material, or

c. The addition of a supplemental prospectus (sometimes referred to as a "sticker").

.03 Section 711, *Filings Under Federal Securities Statutes*, paragraph .05, states, "Because a registration statement under the Securities Act of 1933 speaks as of its effective date, the independent accountant whose report is included in such a registration statement has a statutory responsibility that is determined in the light of the circumstances on that date." The independent accountant's statutory responsibility regarding information covered by his report and included in a registration statement is specified in Section 11 of the 1933 Act. Section 11(b)(3)(B) states that the accountant will not be held liable if he can sustain a burden of proof that "he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." To sustain the burden of proof that he has made a "reasonable investigation" as of the effective date, the accountant performs subsequent events procedures (as described in section 711.10 and .11) to a date as close to the effective date of the registration statement as is reasonable and practicable in the circumstances.

.04 In connection with Rule 415 shelf registrations, under what circumstances does the independent accountant have a responsibility to perform subsequent events procedures after the original effective date of the registration statement?

.05 *Interpretation*—As discussed in more detail below, in general, the accountant should perform the subsequent events procedures described in section 711.10 and .11, when either:

a. A post-effective amendment to the shelf registration statement, as defined by SEC rules, is filed pursuant to Item 512(a) of Regulation S-K,[1] or

b. A 1934 Act filing that includes or amends audited financial statements is incorporated by reference into the shelf registration statement.

.06 When a post-effective amendment is filed pursuant to the registrant's undertaking required by Item 512 of Regulation S-K, a shelf registration statement is considered to have a new effective date because Item 512(a)(2) of Regulation S-K states, ". . . for the purpose of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement. . . ." Accordingly, in such cases, the accountant should perform subsequent events procedures to a date as close to the new effective date of the registration statement as is reasonable and practicable in the circumstances.

.07 Item 512(b) of Regulation S-K states that for purposes of determining any liability under the Securities Act of 1933 each filing of a registrant's annual report (Form 10-K) and each filing of an employee benefit plan annual report (Form 11-K) that is incorporated by reference into a shelf registration statement is deemed to be a new registration statement relating to the securities offering. Accordingly, when a Form 10-K or Form 11-K is incorporated by reference into a shelf registration statement, the accountant should perform subsequent events procedures to a date as close to the date of the filing of the Form 10-K or Form 11-K as is reasonable and practicable in the circumstances and date his consent as of that date.

.08 In many circumstances, a Form 10-Q, Form 8-K, or other 1934 Act filing can be incorporated by reference into a shelf registration statement (sometimes this occurs automatically—for example, in a Form S-3 or Form S-8) without the need for a post-effective amendment. In those circumstances, the accountant has no responsibility to perform subsequent events procedures unless the filing includes or amends audited financial statements—for example, a Form 8-K that includes audited financial statements of an acquired company. In these latter circumstances, when the filing is incorporated into a registration statement, SEC rules require a currently dated consent of the accountant who audited those statements, and that accountant should perform subsequent events procedures to a date as close to the date of the incorporation by reference of the related material as is reasonable and practicable in the circumstances.[2]

.09 In addition, an accountant's report on a review of interim financial information contained in a Form 10-Q may also include his report on the information presented in the condensed year-end balance sheet that has also been included in the form and has been derived from the latest audited annual balance sheet. (See section 552, *Reporting on Condensed Financial Statements*

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[1] Item 512(a) of Regulation S-K provides that the registrant is required to undertake to file a post-effective amendment to a shelf registration statement to (*a*) file updated financial statements pursuant to section 10(*a*)(3) of the Securities Act of 1933, (*b*) reflect a "fundamental change" in the information in the registration statement arising from facts or events occurring after the effective date of the registration statement or previous post-effective amendments, or (*c*) include new material information regarding the plan of distribution.

[2] Typically in such cases, the affected audited financial statements are not those of the registrant, and accordingly, there would be no requirement for the registrant's auditor to update his subsequent events procedures with respect to the registrant's financial statements.

and Selected Financial Data, paragraph .08.) When the Form 10-Q is incorporated by reference into the shelf registration (which may occur automatically), the report on the year-end condensed balance sheet may be considered a report of an "expert." Because it is not clear what the accountant's responsibility is in those circumstances, the accountant should perform subsequent events procedures (as described in section 711.10 and .11) to a date as close to the date of the incorporation by reference of the Form 10-Q as is reasonable and practicable in the circumstances.

.10 One of the subsequent events procedures described in section 711 is to "read the entire prospectus and other pertinent portions of the registration statement." The reading of the entire prospectus (including any supplemental prospectuses and documents incorporated by reference—such as Form 10-Ks, 10-Qs, and 8-Ks) and the other procedures described in section 711.10 and .11, help assure that the accountant has fulfilled his statutory responsibilities under the 1933 Act to perform a "reasonable investigation."

.11 When a shelf registration statement is updated by a supplemental prospectus (or "sticker"), the effective date of the registration statement is considered to be unchanged since the supplemental prospectus does not constitute an amendment to the registration statement, and, consequently, no posteffective amendment has been filed. Accordingly, an accountant has no responsibility to update his performance of subsequent events procedures through the date of the supplemental prospectus or sticker. The accountant, however, may nevertheless become aware that facts may have existed at the date of his report that might have affected his report had he then been aware of those facts. Section 711.12 and .13, provide guidance on the accountant's response to subsequent events and subsequently discovered facts.

[Issue Date: May, 1983.]

2. Consenting to be Named as an Expert in an Offering Document in Connection With Securities Offerings Other Than Those Registered Under the Securities Act of 1933

.12 *Question*—Should the auditor consent to be named, or referred to, as an expert in an offering document in connection with securities offerings other than those registered under the Securities Act of 1933 (the Act)?

.13 *Interpretation*—No. The term "expert" has a specific statutory meaning under the Act.[3] The act states that anyone who purchases a security registered under the Act may sue specified persons if the registration statement contains an untrue statement or omits to state a material fact. Those persons who may be sued include "every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement." These persons are typically referred to as "experts." Auditors sign a statement, known as a consent, in which they agree to be identified as experts in a section of the registration statement.

[3] If the term "expert" is defined under applicable state law, for instance, the accountant may agree to be named as an expert in an offering document in an intra-state securities offering. The accountant may also agree to be named as an expert, as that term is used by the Office of Thrift Supervision (OTS), in securities offering documents which are subject to the jurisdiction of the OTS.

.14 Outside the 1933 Act arena, however, the term "expert" is typically undefined and the auditor's responsibility, as a result of the use of that term, is also undefined.

.15 When a client wishes to make reference to the auditor's role in an offering document in connection with a securities offering that is not registered under the Act, the caption "Independent Auditors" should be used to title that section of the document; the caption "Experts" should not be used, nor should the auditors be referred to as experts anywhere in the document. The following paragraph should be used to describe the auditors role.

Independent Auditors

> The financial statements as of December 31, 19XX and for the year then ended, included in this offering circular, have been audited by ABC, independent auditors, as stated in their report(s) appearing herein.

If the client refuses to delete from the offering document the reference to the auditors as experts, the auditor should not permit inclusion of the auditor's report in the offering document.

[Issue Date: June, 1992; Amended: March, 1995.]

3. Consenting to the Use of an Audit Report in an Offering Document in Securities Offerings Other Than One Registered Under the Securities Act of 1933

.16 *Question*—May the auditor consent to the use of his or her audit report in an offering document other than one registered under the Securities Act of 1933?

.17 *Interpretation*—When an auditor's report is included in an offering document other than one registered under the Securities Act of 1933, it is not usually necessary for the accountant to provide a consent. If the accountant is requested to provide a consent, he or she may do so. The following is example language the accountant might use:

> We agree to the inclusion in this offering circular of our report, dated February 5, 19XX, on our audit of the financial statements of [name of entity].

[Issue Date: June, 1992.]

AU Section 722

Interim Financial Information

(Supersedes SAS No. 71)

Source: SAS No. 100; Auditing Standard No. 2; Auditing Standard No. 5; Auditing Standard Nos. 8–15; Auditing Standard No. 16.

Effective for interim periods within fiscal years beginning after December 15, 2002.

Introduction

.01 The purpose of this section is to establish standards and provide guidance on the nature, timing, and extent of the procedures to be performed by an independent accountant when conducting a review of *interim financial information* (as that term is defined in paragraph .02 of this section). The three general standards discussed in section 150, *Generally Accepted Auditing Standards*, paragraph .02), are applicable to a review of interim financial information conducted in accordance with this section. This section provides guidance on the application of the field work and reporting standards to a review of interim financial information, to the extent those standards are relevant.

.02 For purposes of this section, the term *interim financial information* means financial information or statements covering a period less than a full year or for a 12-month period ending on a date other than the entity's fiscal year end.

.03 *[The following paragraph is effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release 2007-005.]*

The Securities and Exchange Commission (SEC) requires[1] a registrant to engage an independent accountant to review the registrant's interim financial information, in accordance with this section, before the registrant files its quarterly report on Form 10-Q or Form 10-QSB. The SEC also requires management, with the participation of the principal executive and financial officers (the certifying officers) to make certain quarterly and annual certifications with respect to the company's internal control over financial reporting.[2] Although this section does not require an accountant to issue a written report on a review of interim financial information, the SEC requires that an accountant's review report be filed with the interim financial information if, in any filing, the entity states that the interim financial information has been reviewed by an independent public accountant. Paragraphs .37 through .46 of this section provide reporting guidance for a review of interim financial information.

[Note deleted; effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release 2007-005.]

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[1] The Securities and Exchange Commission (SEC) requirement is set forth in Rule 10-01(d) of Regulation S-X for Form 10-Q and item 310(b) of Regulation S-B for Form 10-QSB.

[2] See Section 302 of the Sarbanes-Oxley Act of 2002, and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), (17 C.F.R. §240.13a-14a or 17 C.F.R. §240.15d-14a), whichever applies.

.04 Section 315, *Communications Between Predecessor and Successor Auditors*, requires a successor auditor to contact the entity's predecessor auditor and make inquiries of the predecessor auditor in deciding whether to accept appointment as an entity's independent auditor. Such inquiries should be completed before accepting an engagement to perform an initial review of an entity's interim financial information.

Applicability[2a]

.05 An accountant may conduct, in accordance with this section, a review of the interim financial information of an SEC registrant[3] or of a non-SEC registrant that makes a filing with a regulatory agency[4] in preparation for a public offering or listing, if the entity's latest annual financial statements have been or are being audited. The interim financial information may be presented in the form of financial statements or in a summarized form that purports to conform with generally accepted accounting principles[5] and applicable regulatory requirements, for example, Article 10 of Regulation S-X for Form 10-Q.

.06 Many SEC registrants are required by item 302(a) of Regulation S-K to include selected quarterly financial data (that is, interim financial information for each full quarter within the two most recent fiscal years and any subsequent interim period for which financial statements are included or are required to be included) in their annual reports and in certain other SEC filings. Consequently, a review of the entity's fourth quarter interim financial information must be conducted even though a quarterly report for the fourth quarter is not filed on Form 10-Q. Furthermore, an accountant performing an initial audit of an entity's annual financial statements that includes selected quarterly data who has not previously reviewed one or more of the quarters in that year should perform a review of those quarters, in accordance with this section, in order to report on the audited financial statements containing such interim financial information.

Objective of a Review of Interim Financial Information

.07 *[The following paragraph is effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release 2007-005.]*

The objective of a review of interim financial information pursuant to this section is to provide the accountant with a basis for communicating whether he

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[2a] *[The following footnote has been renumbered from footnote 2 to footnote 2a.]* Statements on Standards for Accounting and Review Services provide guidance for review engagements for which this section is not applicable.

[3] This section also is applicable to a review of the interim financial information of a subsidiary, corporate joint venture, or investee of an SEC registrant, when that review is performed in the context of the review of the interim financial information of the SEC registrant itself.

[4] For purposes of this section, a *regulatory agency* is the SEC and the following agencies with which an entity files periodic reports pursuant to the Securities Exchange Act of 1934: Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve System, and Office of Thrift Supervision.

[5] Accounting Principles Board (APB) Opinion No. 28, *Interim Financial Reporting*, outlines the application of U.S. generally accepted accounting principles to the determination of income when interim financial information is presented, provides for the use of estimated effective income tax rates, and specifies certain disclosure requirements for summarized interim financial information issued by public companies. Footnote 3 of section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, paragraph .10, indicates that, for SEC registrants, rules and interpretive releases of the SEC have an authority similar to that of category "a" accounting principles.

or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles. The objective of a review of interim financial information differs significantly from that of an audit conducted in accordance with generally accepted auditing standards. A review of interim financial information does not provide a basis for expressing an opinion about whether the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles. A review consists principally of performing analytical procedures and making inquiries of persons responsible for financial and accounting matters, and does not contemplate (*a*) tests of accounting records through inspection, observation, or confirmation; (*b*) tests of controls to evaluate their effectiveness; (*c*) obtaining corroborating evidence in response to inquiries; or (*d*) performing certain other procedures ordinarily performed in an audit. A review may bring to the accountant's attention significant matters affecting the interim financial information, but it does not provide assurance that the accountant will become aware of all significant matters that would be identified in an audit. Paragraph .22 of this section provides guidance to the accountant if he or she becomes aware of information that leads him or her to believe that the interim financial information may not be in conformity with generally accepted accounting principles. Likewise, the auditor's responsibility as it relates to management's quarterly certifications on internal control over financial reporting is different from the auditor's responsibility as it relates to management's annual assessment of internal control over financial reporting. The auditor should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302 of the Act.

Note: The auditor's responsibilities for evaluating management's certification disclosures about internal control over financial reporting take effect beginning with the first quarter after the company's first annual assessment of internal control over financial reporting as described in Item 308(a)(3) of Regulations S-B and SK.

Establishing an Understanding With the Audit Committee

.08 *[The preceding heading and following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

The accountant should establish an understanding of the terms of an engagement to review interim financial information with the audit committee or others with equivalent authority and responsibility (hereafter referred to as the audit committee). [6] This understanding includes the objective of the review of interim financial information, the responsibilities of the accountant, and the responsibilities of management. Such an understanding reduces the risk that either the accountant or the audit committee may misinterpret the needs or expectations of the other party. The accountant should record this understanding of the terms of the engagement in an engagement letter and should provide the engagement

[6] *See* paragraph .16 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice. [Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

letter to the audit committee. The accountant should have the engagement letter executed by the appropriate party or parties on behalf of the company. If the appropriate party or parties are other than the audit committee, or its chair on behalf of the audit committee, the accountant should determine that the audit committee has acknowledged and agreed to the terms of the engagement. If the accountant believes he or she cannot establish an understanding of the terms of an engagement to review interim financial information with the audit committee, the accountant should decline to accept, continue, or perform the engagement.

.09 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

An understanding with the audit committee regarding a review of interim financial information generally includes the following matters:

- The objective of a review of interim financial information is to provide the accountant with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with accounting principles generally accepted in the United States of America.
- Management is responsible for the entity's interim financial information.
- Management is responsible for establishing and maintaining effective internal control over financial reporting.
- Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.
- Management is responsible for making all financial records and related information available to the accountant.
- At the conclusion of the engagement, management will provide the accountant with a letter confirming certain representations made during the review.
- Management is responsible for adjusting the interim financial information to correct material misstatements. Although a review of interim financial information is not designed to obtain reasonable assurance that the interim financial information is free from material misstatement, management also is responsible for affirming in its representation letter to the accountant that the effects of any uncorrected misstatements aggregated by the accountant during the current engagement and pertaining to the current-year period(s) under review are immaterial, both individually and in the aggregate, to the interim financial information taken as a whole.
- The accountant is responsible for conducting the review in accordance with standards established by the AICPA. A review of interim financial information consists principally of performing analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, the accountant will not express an opinion on the interim financial information.

- A review includes obtaining sufficient knowledge of the entity's business and its internal control as it relates to the preparation of both annual and interim financial information to:
  - — Identify the types of potential material misstatements in the interim financial information and consider the likelihood of their occurrence.
  - — Select the inquiries and analytical procedures that will provide the accountant with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles.

[The following bullet is effective for reviews of interim periods ending on or after November 15, 2004, for accelerated filers, and for reviews of interim periods after fiscal years ending on or after July 15, 2005, for all other issuers. See PCAOB Release No. 2004-008.]

- A review is not designed to provide assurance on internal control or to identify significant deficiencies. However, the accountant is responsible for communicating with the audit committee or others with equivalent authority or responsibility, regarding any significant deficiencies that come to his or her attention.

The Accountant's Knowledge of the Entity's Business and Its Internal Control

.10 To perform a review of interim financial information, the accountant should have sufficient knowledge of the entity's business and its internal control as they relate to the preparation of both annual and interim financial information to:

- Identify the types of potential material misstatements in the interim financial information and consider the likelihood of their occurrence.
- Select the inquiries and analytical procedures that will provide the accountant with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles.

.11 In planning a review of interim financial information, the accountant should perform procedures to update his or her knowledge of the entity's business and its internal control to (*a*) aid in the determination of the inquiries to be made and the analytical procedures to be performed and (*b*) identify particular events, transactions, or assertions to which the inquiries may be directed or analytical procedures applied. Such procedures should include:

- Reading documentation of the preceding year's audit and of reviews of prior interim period(s) of the current year and corresponding quarterly and year-to-date interim period(s) of the prior year to the extent necessary, based on the accountant's judgment, to enable the accountant to identify matters that may affect the current-period interim financial information. In reading such documents, the accountant should specifically consider the nature of any (*a*) corrected material misstatements; (*b*) matters identified in

any summary of uncorrected misstatements;[7] (*c*) identified risks of material misstatement due to fraud, including the risk of management override of controls; and (*d*) significant financial accounting and reporting matters that may be of continuing significance, such as weaknesses in internal control.

- Reading the most recent annual and comparable prior interim period financial information.
- Considering the results of any audit procedures performed with respect to the current year's financial statements.
- Inquiring of management about changes in the entity's business activities.
- Inquiring of management about whether significant changes in internal control, as it relates to the preparation of interim financial information, have occurred subsequent to the preceding annual audit or prior review of interim financial information, including changes in the entity's policies, procedures, and personnel, as well as the nature and extent of such changes.

.12 In an initial review of interim financial information, the accountant should perform procedures that will enable him or her to obtain sufficient knowledge of the entity's business and its internal control to address the objectives discussed in paragraph .07 of this section. As part of the procedures to obtain this knowledge, the accountant performing an initial review of interim financial information makes inquiries of the predecessor accountant and reviews the predecessor accountant's documentation for the preceding annual audit and for any prior interim periods in the current year that have been reviewed by the predecessor accountant if the predecessor accountant permits access to such documentation.[8] In doing so, the accountant should specifically consider the nature of any (*a*) corrected material misstatements; (*b*) matters identified in any summary of uncorrected misstatements; (*c*) identified risks of material misstatement due to fraud, including the risk of management override of controls; and (*d*) significant financial accounting and reporting matters that may be of continuing significance, such as weaknesses in internal control. However, the inquiries made and analytical procedures performed or other procedures performed in the initial review and the conclusions reached are solely the responsibility of the successor accountant. If the successor accountant is reporting on the review, the successor accountant should not make reference to the report or work of the predecessor accountant as the basis, in part, for the successor accountant's own report. If the predecessor accountant does not respond to the successor accountant's inquiries, or does not allow the successor accountant to review the predecessor accountant's documentation, the successor accountant should use alternative procedures to obtain knowledge of the matters discussed in this paragraph.

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[7] 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. Paragraphs .25 and .26 of this section describe the accountant's consideration of such misstatements in a review of interim financial information. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

[8] The accountant also may consider reviewing the predecessor accountant's documentation related to reviews of interim period(s) in the prior year.

.13 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

The accountant who has audited the entity's financial statements for one or more annual periods would have acquired sufficient knowledge of an entity's internal control as it relates to the preparation of annual financial information and may have acquired such knowledge with respect to interim financial information. If the accountant has not audited the most recent annual financial statements, the accountant should perform procedures to obtain such knowledge. Knowledge of an entity's internal control, as it relates to the preparation of both annual and interim financial information, includes knowledge of the relevant aspects of the control environment, the entity's risk assessment process, control activities, information and communication, and monitoring, as those terms are defined in Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. Internal control over the preparation of interim financial information may differ from internal control over the preparation of annual financial statements because certain accounting principles and practices used for interim financial information may differ from those used for the preparation of annual financial statements, for example, the use of estimated effective income tax rates for the preparation of interim financial information, which is prescribed by Accounting Principles Board (APB) Opinion No. 28, *Interim Financial Reporting*.

.14 A restriction on the scope of the review may be imposed if the entity's internal control appears to contain deficiencies so significant that it would be impracticable for the accountant, based on his or her judgment, to effectively perform review procedures that would provide a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles.[9]

Analytical Procedures, Inquiries, and Other Review Procedures

.15 Procedures for conducting a review of interim financial information generally are limited to analytical procedures, inquiries, and other procedures that address significant accounting and disclosure matters relating to the interim financial information to be reported. The accountant performs these procedures to obtain a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles. The specific inquiries made and the analytical and other procedures performed should be tailored to the engagement based on the accountant's knowledge of the entity's business and its internal control. The accountant's knowledge of an entity's business and its internal control influences the inquiries made and analytical procedures performed. For example, if the accountant becomes aware of a significant change in the entity's control activities at a particular location, the accountant may consider (*a*) making additional inquiries, such as whether management monitored the changes and considered whether they were operating as intended, (*b*) employing analytical procedures with a more precise expectation, or (*c*) both.

[9] See paragraph .28 of this section.

.16 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

Analytical procedures and related inquiries. The accountant should apply analytical procedures to the interim financial information to identify and provide a basis for inquiry about the relationships and individual items that appear to be unusual and that may indicate a material misstatement. Analytical procedures, for the purposes of this section, should include:

- Comparing the quarterly interim financial information with comparable information for the immediately preceding interim period and the quarterly and year-to-date interim financial information with the corresponding period(s) in the previous year, giving consideration to knowledge about changes in the entity's business and specific transactions.
- Considering plausible relationships among both financial and, where relevant, nonfinancial information. The accountant also may wish to consider information developed and used by the entity, for example, information in a director's information package or in a senior committee's briefing materials.
- Comparing recorded amounts, or ratios developed from recorded amounts, to expectations developed by the accountant. The accountant develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the accountant's understanding of the entity and the industry in which the entity operates (see paragraph .17 of this section).
- Comparing disaggregated revenue data, for example, comparing revenue reported by month and by product line or operating segment during the current interim period with that of comparable prior periods.

See Appendix A [paragraph .54] of this section for examples of analytical procedures an accountant may consider performing when conducting a review of interim financial information. The accountant may find the guidance in section 329, *Substantive Analytical Procedures*, useful in conducting a review of interim financial information.

.17 Expectations developed by the accountant in performing analytical procedures in connection with a review of interim financial information ordinarily are less precise than those developed in an audit. Also, in a review the accountant ordinarily is not required to corroborate management's responses with other evidence. However, the accountant should consider the reasonableness and consistency of management's responses in light of the results of other review procedures and the accountant's knowledge of the entity's business and its internal control.[10]

.18 *[The following paragraph is effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release 2007-005.]*

Inquiries and other review procedures. The following are inquiries the accountant should make and other review procedures the accountant should perform when conducting a review of interim financial information:

a. Reading the available minutes of meetings of stockholders, directors, and appropriate committees, and inquiring about matters dealt with at meetings for which minutes are not available, to

[10] See paragraph .22 of this section.

identify matters that may affect the interim financial information.

b. Obtaining reports from other accountants, if any, who have been engaged to perform a review of the interim financial information of significant components of the reporting entity, its subsidiaries, or its other investees, or inquiring of those accountants if reports have not been issued.[11]

c. Inquiring of members of management who have responsibility for financial and accounting matters concerning:

- Whether the interim financial information has been prepared in conformity with generally accepted accounting principles consistently applied.
- Unusual or complex situations that may have an effect on the interim financial information. (See Appendix B [paragraph .55] of this section for examples of unusual or complex situations about which the accountant ordinarily would inquire of management.)
- Significant transactions occurring or recognized in the last several days of the interim period.
- The status of uncorrected misstatements identified during the previous audit and interim review (that is, whether adjustments had been recorded subsequent to the prior audit or interim period and, if so, the amounts recorded and period in which such adjustments were recorded).
- Matters about which questions have arisen in the course of applying the review procedures
- Events subsequent to the date of the interim financial information that could have a material effect on the presentation of such information.
- Their knowledge of any fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements.
- Whether they are aware of allegations of fraud or suspected fraud affecting the entity, for example, received in communications from employees, former employees, analysts, regulators, short sellers, or others.
- Significant journal entries and other adjustments.
- Communications from regulatory agencies.
- Significant deficiencies, including material weaknesses, in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data.

d. Obtaining evidence that the interim financial information agrees or reconciles with the accounting records. For example, the accountant may compare the interim financial information to (1)

[11] In these circumstances, the accountant ordinarily is in a position similar to that of an auditor who acts as principal auditor (see section 543, *Part of Audit Performed by Other Independent Auditors*) and makes use of the work or reports of other auditors in the course of an audit of financial statements.

the accounting records, such as the general ledger; (2) a consolidating schedule derived from the accounting records; or (3) other supporting data in the entity's records. In addition, the accountant should consider inquiring of management as to the reliability of the records to which the interim financial information was compared or reconciled.

e. Reading the interim financial information to consider whether, based on the results of the review procedures performed and other information that has come to the accountant's attention, the information to be reported conforms with generally accepted accounting principles.

f. Reading other information that accompanies the interim financial information and is contained in reports (1) to holders of securities or beneficial interests or (2) filed with regulatory authorities under the Securities Exchange Act of 1934 (such as Form 10-Q or 10-QSB), to consider whether such information or the manner of its presentation is materially inconsistent with the interim financial information.[12] If the accountant concludes that there is a material inconsistency, or becomes aware of information that he or she believes is a material misstatement of fact, the action taken will depend on his or her judgment in the particular circumstances. In determining the appropriate course of action, the accountant should consider the guidance in section 550, *Other Information in Documents Containing Audited Financial Statements*, paragraphs .04 through .06).

g. Evaluating management's quarterly certifications about internal control over financial reporting by performing the following procedures—

- Inquiring of management about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information that could have occurred subsequent to the preceding annual audit or prior review of interim financial information;
- Evaluating the implications of misstatements identified by the auditor as part of the auditor's other interim review procedures as they relate to effective internal control over financial reporting; and
- Determining, through a combination of observation and inquiry, whether any change in internal control over financial reporting has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

.19 Many of the aforementioned review procedures can be performed before or simultaneously with the entity's preparation of the interim financial information. For example, it may be practicable to update the understanding of the entity's internal control and begin reading applicable minutes before the end of an interim period. Performing some of the review procedures earlier in the interim period also permits early identification and consideration of significant accounting matters affecting the interim financial information.

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[12] The principal accountant also may request other accountants involved in the engagement, if any, to read the other information.

.20 *Inquiry concerning litigation, claims, and assessments*. A review of interim financial information does not contemplate obtaining corroborating evidence for responses to inquiries concerning litigation, claims, and assessments (see paragraph .07 of this section). Consequently, it ordinarily is not necessary to send an inquiry letter to an entity's lawyer concerning litigation, claims, and assessments. However, if information comes to the accountant's attention that leads him or her to question whether the interim financial information departs from generally accepted accounting principles[13] with respect to litigation, claims, or assessments, and the accountant believes the entity's lawyer may have information concerning that question, an inquiry of the lawyer concerning the specific question is appropriate.

.21 *Inquiry concerning an entity's ability to continue as a going concern.* A review of interim financial information is not designed to identify conditions or events that may indicate substantial doubt about an entity's ability to continue as a going concern. However, such conditions or events may have existed at the date of prior-period financial statements.[14] In addition, in the course of performing review procedures on the current-period interim financial information, the accountant may become aware of conditions or events that might be indicative of the entity's possible inability to continue as a going concern. In either case, the accountant should (*a*) inquire of management as to its plans for dealing with the adverse effects of the conditions and events and (*b*) consider the adequacy of the disclosure about such matters in the interim financial information.[15] It ordinarily is not necessary for the accountant to obtain evidence in support of the information that mitigates the effects of the conditions and events.

.22 *Extension of interim review procedures*. If, in performing a review of interim financial information, the accountant becomes aware of information that leads him or her to believe that the interim financial information may not be in conformity with generally accepted accounting principles in all material respects, the accountant should make additional inquiries or perform other procedures that the accountant considers appropriate to provide a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information. For example, if the accountant's interim review procedures lead him or her to question whether a significant sales transaction is recorded in conformity with generally accepted accounting principles, the accountant should perform additional procedures, such as discussing the terms of the transaction with senior marketing and accounting personnel, reading the sales contract, or both, to resolve his or her questions.

.23 *Coordination with the audit*. The accountant performing the review of interim financial information ordinarily will also be engaged to perform an audit of the annual financial statements of the entity. Certain auditing procedures

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[13] In accordance with APB Opinion No. 28 and Article 10 of Regulation S-X, contingencies and other uncertainties that could be expected to affect the fairness of the presentation of financial data at an interim date should be disclosed in interim reports in the same manner required for annual reports. Such disclosures should be repeated in interim and annual reports until the contingencies have been removed, resolved, or become immaterial. The significance of a contingency or uncertainty should be judged in relation to annual financial statements.

[14] For purposes of this section, "conditions or events that existed at the date of prior-period financial statements" include (*a*) substantial doubt about the entity's ability to continue as a going concern that existed at the preceding year end, regardless of whether the substantial doubt was alleviated by the auditor's consideration of management's plans, or (*b*) conditions and events disclosed in the immediately preceding interim period.

[15] Information that might be disclosed is set forth in section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, paragraph .10. If the accountant determines that the disclosure about the entity's possible inability to continue as a going concern is inadequate, a departure from generally accepted accounting principles exists.

may be performed concurrently with the review of interim financial information. For example, information gained from reading the minutes of meetings of the board of directors in connection with the review also may be used for the annual audit. Also, there may be significant or unusual transactions occurring during the interim period under review for which the auditing procedures that would need to be performed for purposes of the audit of the annual financial statements could be performed, to the extent practicable, at the time of the interim review, for example, business combinations, restructurings, or significant revenue transactions.

Written Representations From Management

.24 Written representations from management should be obtained for all interim financial information presented and for all periods covered by the review. Specific representations should relate to the following matters:[16]

Financial Statements

a. Management's acknowledgement of its responsibility for the fair presentation of the interim financial information in conformity with generally accepted accounting principles.

b. Management's belief that the interim financial information has been prepared and presented in conformity with generally accepted accounting principles applicable to interim financial information.

Internal Control

c. Disclosure of all significant deficiencies, including material weaknesses, in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data.

d. Acknowledgment of management's responsibility for the design and implementation of programs and controls to prevent and detect fraud.

e. Knowledge of fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements.

f. Knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.

Completeness of Information

g. Availability of all financial records and related data.

h. Completeness and availability of all minutes of meetings of stockholders, directors, and committees of directors.

i. Communications with regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.

j. Absence of unrecorded transactions.

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[16] For additional guidance regarding written management representations, see section 333, *Management Representations*, paragraphs .08 through .12.

Recognition, Measurement, and Disclosure

k. Management's belief that the effects of any uncorrected financial statement misstatements aggregated by the accountant during the current review engagement and pertaining to the interim period(s) in the current year are immaterial, both individually and in the aggregate, to the interim financial information taken as a whole. (A summary of such items should be included in or attached to the letter.)[17]

l. Plans or intentions that may materially affect the carrying value or classification of assets or liabilities.

m. Information concerning related-party transactions and amounts receivable from or payable to related parties.

n. Guarantees, whether written or oral, under which the entity is contingently liable.

o. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

p. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the interim financial information or as a basis for recording a loss contingency.

q. Unasserted claims or assessments that are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*.

r. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.

s. Satisfactory title to all owned assets, liens or encumbrances on such assets, and assets pledged as collateral.

t. Compliance with aspects of contractual agreements that may affect the interim financial information.

Subsequent Events

u. Information concerning subsequent events.

The representation letter ordinarily should be tailored to include additional representations from management related to matters specific to the entity's business or industry. Appendix C [paragraph .56] of this section presents illustrative representation letters.

Evaluating the Results of Interim Review Procedures

.25 A review of interim financial information is not designed to obtain reasonable assurance that the interim financial information is free of material misstatement. However, based on the review procedures performed, the accountant may become aware of *likely misstatements*. In the context of an interim review, a likely misstatement is the accountant's best estimate of the total misstatement in the account balances or classes of transactions on which he or she has performed review procedures. The accountant should accumulate for further evaluation likely misstatements identified in performing the review

[17] If a summary of uncorrected misstatements is unnecessary because there were no uncorrected misstatements identified, this representation should be eliminated.

procedures. The accountant may designate an amount below which misstatements need not be accumulated, based on his or her professional judgment. However, the accountant should recognize that aggregated misstatements of relatively small amounts could have a material effect on the interim financial information.

.26 Misstatements identified by the accountant or brought to the accountant's attention, including inadequate disclosure,[18] should be evaluated individually and in the aggregate to determine whether material modification should be made to the interim financial information for it to conform with generally accepted accounting principles.[19] The accountant should use his or her professional judgment in evaluating the materiality of any likely misstatements that the entity has not corrected. The accountant should consider matters such as (*a*) the nature, cause (if known), and amount of the misstatements; (*b*) whether the misstatements originated in the preceding year or interim periods of the current year; (*c*) materiality judgments made in conjunction with the current or prior year's annual audit; and (*d*) the potential effect of the misstatements on future interim or annual periods.[20]

.27 When evaluating whether uncorrected likely misstatements, individually or in the aggregate, are material, the accountant also should (*a*) consider the appropriateness of offsetting a misstatement of an estimated amount with a misstatement of an item capable of precise measurement and (*b*) recognize that an accumulation of immaterial misstatements in the balance sheet could contribute to material misstatements in future periods.

.28 When an accountant is unable to perform the procedures he or she considers necessary to achieve the objective of a review of interim financial information, or the client does not provide the accountant with the written representations the accountant believes are necessary, the review will be incomplete. An incomplete review is not an adequate basis for issuing a review report. If the accountant cannot complete the review, the accountant should communicate

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[18] Rule 10-01 of Regulation S-X states—

The interim financial information shall include disclosures either on the face of the financial statements or in accompanying footnotes sufficient so as to make the interim information presented not misleading. Registrants may presume that users of the interim financial information have read or have access to the audited financial statements for the preceding fiscal year and that the adequacy of additional disclosure needed for a fair presentation, except in regard to material contingencies, may be determined in that context. Accordingly, footnote disclosure which would substantially duplicate the disclosure contained in the most recent annual report to security holders or latest audited financial statements, such as a statement of significant accounting policies and practices, details of accounts which have not changed significantly in amount or composition since the end of the most recently completed fiscal year, and detailed disclosures prescribed by Rule 4-08 of this Regulation, may be omitted. However, disclosure shall be provided where events subsequent to the end of the most recent fiscal year have occurred which have a material impact on the registrant. Disclosures should encompass for example, significant changes since the end of the most recently completed fiscal year in such items as: accounting principles and practices; estimates inherent in the preparation of the financial statements; status of long-term contracts; capitalization including significant new borrowings or modification of existing financing arrangements; and the reporting entity resulting from business combinations or dispositions. Notwithstanding the above, where material contingencies exist, disclosure of such matters shall be provided even though a significant change since year end may not have occurred.

[19] APB Opinion No. 28 describes the applicability of generally accepted accounting principles to interim financial information and indicates the types of disclosures necessary to report on a meaningful basis for a period of less than a full year. Paragraph 29 of Opinion No. 28 provides guidance on assessing materiality in interim periods. For example, the Opinion states, "In determining materiality for the purpose of reporting the cumulative effect of an accounting change or correction of an error, amounts should be related to the estimated income for the full fiscal year and also to the effect on the trend of earnings."

[20] *[Footnote deleted, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

that information in accordance with the guidance in paragraphs .29 through .31 of this section. Nevertheless, if the accountant has become aware of material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles, such matters should be communicated pursuant to paragraphs .29 through .31 of this section.

Communications to Management, Audit Committees, and Others

.29 *[The following paragraph is effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release 2007-005.]*

As a result of conducting a review of interim financial information, the accountant may become aware of matters that cause him or her to believe that—

a. material modification should be made to the interim financial information for it to conform with generally accepted accounting principles;

b. modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies; and

c. the entity filed the Form 10-Q or Form 10-QSB before the completion of the review.

In such circumstances, the accountant should communicate the matter(s) to the appropriate level of management as soon as practicable.

.30 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

If management does not respond appropriately to the accountant's communication within a reasonable period of time, the accountant should communicate these matters to the audit committee as soon as practicable and prior to the registrant filing its periodic report with the SEC. The communications to the audit committee should be made and documented in accordance with paragraph 25 of Auditing Standard No. 16, *Communications with Audit Committees*.

.31 If, in the accountant's judgment, the audit committee does not respond appropriately to the accountant's communication within a reasonable period of time, the accountant should evaluate whether to resign from the engagement to review the interim financial information and as the entity's auditor. The accountant may wish to consult with his or her attorney when making these evaluations.

.32 *[The following paragraph is effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release 2007-005.]*

If the auditor becomes aware of information indicating that fraud or an illegal act has or may have occurred, the auditor must also determine his or her responsibilities under AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[21]

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[21] See 15 U.S.C. § 78j-1.

.33 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

[The following paragraph is effective for reviews of interim periods ending on or after November 15, 2007. See PCAOB Release 2007-005.]

When conducting a review of interim financial information, the accountant may become aware of matters relating to internal control that may be of interest to the audit committee. Matters that should be reported to the audit committee are referred to as significant deficiencies. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting, that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting.[22] The accountant should communicate significant deficiencies or material weaknesses of which the accountant has become aware to the audit committee or those responsible for oversight of the company's financial reporting in a timely manner and prior to the registrant filing its periodic report with the SEC.

.34 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

When conducting a review of interim financial information, the accountant also should determine whether any of the matters described in Auditing Standard No. 16, *Communications with Audit Committees*, as they relate to interim financial information, have been identified. If such matters have been identified, the accountant should communicate them to the audit committee in a timely manner and prior to the registrant filing its periodic report with the SEC. For example, the accountant should communicate a description of the process management used to develop the critical accounting estimates; a change in a significant accounting policy affecting the interim financial information; misstatements that, either individually or in the aggregate, could have a significant effect on the entity's financial reporting process; and uncorrected misstatements aggregated by the accountant that management determined to be immaterial, both individually and in the aggregate, to the interim financial statements taken as a whole. [23] As part of its communications to the audit committee, management might communicate some or all of the matters related to the company's accounting policies, practices, estimates, and significant unusual transactions described in paragraph 12 of Auditing Standard No. 16, *Communications with the Audit Committees*. If management communicates any of these matters, the accountant does not need to communicate them at the same level of detail as management, as long as the accountant (1) participated in management's discussion with the audit committee, (2) affirmatively confirmed to the audit committee that management has adequately communicated these matters, and (3) with respect to critical accounting policies and practices, identified for the audit committee those accounting policies and practices that the accountant considers critical. The accountant should communicate any omitted or inadequately described matters to the audit committee.

.35 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

The objective of a review of interim financial information differs significantly from that of an audit. Therefore, any communication the accountant may make

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[22] [Footnote deleted due to the issuance of Auditing Standard No. 5.]

[23] The schedule of uncorrected misstatements related to accounts and disclosures provided to the audit committee should be the same schedule that was included in or attached to the management representation letter that is described in paragraph .24(*k*) of this section. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

about the entity's accounting policies, practices, estimates, and significant unusual transactions as applied to its interim financial reporting, generally would be limited to the effect of significant events, transactions, and changes in accounting estimates that the accountant considered when conducting the review of interim financial information. Further, interim review procedures do not provide assurance that the accountant will become aware of all matters that might affect the accountant's judgments about the qualitative aspects of the entity's accounting policies and practices that would be identified as a result of an audit.

.36 *[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2012. See PCAOB Release 2012-004.]*

If the accountant has identified matters to be communicated to the audit committee, the accountant should communicate such matters to the audit committee, or at least its chair, in a timely manner and prior to the registrant filing its periodic report with the SEC. The communications to the audit committee should be made and documented in accordance with paragraph 25 of Auditing Standard No. 16, *Communications with Audit Committees*.

The Accountant's Report on a Review of Interim Financial Information[24]

Form of Accountant's Review Report

.37 The accountant's review report accompanying interim financial information should consist of:

a. A title that includes the word *independent*.

b. A statement that the interim financial information identified in the report was reviewed.

c. A statement that the interim financial information is the responsibility of the entity's management.

d. A statement that the review of interim financial information was conducted in accordance with standards established by the AICPA.

e. A description of the procedures for a review of interim financial information.

f. A statement that a review of interim financial information is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is an expression of an opinion regarding the financial statements taken as a whole, and accordingly, no such opinion is expressed.

g. A statement about whether the accountant is aware of any material modifications that should be made to the accompanying interim financial information for it to conform with generally accepted accounting principles. The statement should include an identification of the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles).

[24] Paragraphs .37 through .46 of this section provide reporting guidance for a review of interim financial information; however, an accountant is not required to issue a report on such engagements.

h. The manual or printed signature of the accountant's firm.

i. The date of the review report. (Generally, the report should be dated as of the date of completion of the review procedures.[25])

In addition, each page of the interim financial information should be clearly marked as unaudited.

.38 The following is an example of a review report:[26]

Independent Accountant's Report

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended. This (These) interim financial information (statements) is (are) the responsibility of the company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

.39 An accountant may be engaged to report on a review of comparative interim financial information. The following is an example of a review report on a condensed balance sheet as of March 31, 20X1, the related condensed statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0, and a condensed balance sheet derived from audited financial statements as of December 31, 20X0, that were included in Form 10-Q.[27]

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[25] Other reporting issues related to the dating of reports or subsequent events are similar to those encountered in an audit of financial statements. See sections 530, *Dating of the Independent Auditor's Report*, and 560, *Subsequent Events*.

[26] If interim financial information of a prior period is presented with that of the current period and the accountant has conducted a review of that information, the accountant should report on his or her review of the prior period. An example of the first sentence of such a report follows: "We have reviewed . . . of ABC Company and consolidated subsidiaries as of September 30, 20X1 and 20X2, and for the three-month and nine-month periods then ended. . . ."

[27] Regulation S-X specifies that the following financial information should be provided in filings on Form 10-Q:

a. An interim balance sheet as of the end of the most recent fiscal quarter and a balance sheet as of the end of the preceding fiscal year that may be condensed to the same extent as the interim balance sheet.

(continued)

Independent Accountant's Report

We have reviewed the condensed consolidated balance sheet of ABC Company and subsidiaries as of March 31, 20X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0. These financial statements are the responsibility of the company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the condensed financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of ABC Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 20X0, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.[28]

[*Signature*]

[*Date*]

.40 The accountant may use and make reference to another accountant's review report on the interim financial information of a significant component of a reporting entity. This reference indicates a division of responsibility for performing the review.[29] The following is an example of report including such a reference:

Independent Accountant's Report

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods

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(footnote continued)

b. Interim condensed statements of income for the most recent fiscal quarter, for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding periods of the preceding fiscal year.

c. Interim condensed cash flow statements for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter and for the corresponding period for the preceding fiscal year.

[28] If the auditor's report on the preceding year-end financial statements was other than unqualified, referred to other auditors, or included an explanatory paragraph because of a going-concern matter or an inconsistency in the application of accounting principles, the last paragraph of the illustrative report in paragraph .39 should be appropriately modified.

[29] See section 543, *Part of Audit Performed by Other Independent Auditors*.

then ended. This (These) interim financial information (statements) is (are) the responsibility of the company's management.

We were furnished with the report of other accountants on their review of the interim financial information of DEF subsidiary, whose total assets as of September 30, 20X1, and whose revenues for the three-month and nine-month periods then ended, constituted 15 percent, 20 percent, and 22 percent, respectively, of the related consolidated totals.

We conducted our reviews in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information (statements) consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review and the report of other accountants, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

Modification of the Accountant's Review Report

.41 The accountant's report on a review of interim financial information should be modified for departures from generally accepted accounting principles,[30] which include inadequate disclosure and changes in accounting principle that are not in conformity with generally accepted accounting principles. The existence of substantial doubt about the entity's ability to continue as a going concern or a lack of consistency in the application of accounting principles affecting the interim financial information would not require the accountant to add an additional paragraph to the report, provided that the interim financial information appropriately discloses such matters. Although not required, the accountant may wish to emphasize such matters in a separate explanatory paragraph of the report. See paragraphs .44 and .45 of this section for examples of paragraphs that address matters related to an entity's ability to continue as a going concern.

.42 *Departure from generally accepted accounting principles.* If the accountant becomes aware that the interim financial information is materially affected by a departure from generally accepted accounting principles, he or she should modify the report. The modification should describe the nature of the departure and, if practicable, should state the effects on the interim financial information. Following is an example of such a modification of the accountant's report.

[*Explanatory third paragraph*]

Based on information furnished to us by management, we believe that the company has excluded from property and debt in the accompanying balance sheet certain lease obligations that we believe should be capitalized to conform

[30] If the circumstances contemplated by Rule 203, *Accounting Principles*, are present, the accountant should refer to the guidance in section 508, *Reports on Audited Financial Statements*, paragraph .15).

with accounting principles generally accepted in the United States of America. This information indicates that if these lease obligations were capitalized at September 30, 20X1, property would be increased by $____, long-term debt by $____, and net income and earnings per share would be increased (decreased) by $_____, $_____, $_____, and $_____, respectively, for the three-month and nine-month periods then ended.

[*Concluding paragraph*]

Based on our review, with the exception of the matter(s) described in the preceding paragraph(s), we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

.43 *Inadequate disclosure*. The information necessary for adequate disclosure is influenced by the form and context in which the interim financial information is presented. For example, the disclosures considered necessary for interim financial information presented in accordance with the minimum disclosure requirements of APB Opinion No. 28, paragraph 30, which is applicable to summarized financial statements of public companies, are considerably less extensive than those necessary for annual financial statements that present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.[31] If information that the accountant believes is necessary for adequate disclosure in conformity with generally accepted accounting principles[32] is not included in the interim financial information, the accountant should modify the report and, if practicable, include the necessary information in the report. The following is an example of such a modification of the accountant's report:

[*Explanatory third paragraph*]

Management has informed us that the company is presently contesting deficiencies in federal income taxes proposed by the Internal Revenue Service for the years 20X1 through 20X3 in the aggregate amount of approximately $____, and that the extent of the company's liability, if any, and the effect on the accompanying information (statements) is not determinable at this time. The information (statements) fail(s) to disclose these matters, which we believe are required to be disclosed in conformity with accounting principles generally accepted in the United States of America.

[*Concluding paragraph*]

Based on our review, with the exception of the matter(s) described in the preceding paragraph(s), we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

.44 *Going-concern paragraph was included in the prior year's audit report; conditions giving rise to the paragraph continue to exist.* If (*a*) the auditor's

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[31] APB Opinion No. 28, paragraph 32, states that "there is a presumption that users of summarized interim financial data will have read the latest published annual report, including the financial disclosures required by generally accepted accounting principles and management's commentary concerning the annual financial results, and that the summarized interim data will be viewed in that context." See footnote 18 of this section for additional disclosure requirements.

[32] Such disclosures include those set forth in section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, paragraph .10. If the accountant determines that disclosure about the entity's possible inability to continue as a going concern is inadequate, a departure from generally accepted accounting principles exists.

report for the prior year end contained an explanatory paragraph indicating the existence of substantial doubt about the entity's ability to continue as a going concern, (*b*) the conditions that raised such doubt continued to exist as of the interim reporting date covered by the review, and (*c*) there is adequate and appropriate disclosure about these conditions in the interim financial information, the accountant is not required to modify his or her report. However, the accountant may add an explanatory paragraph to the review report, after the concluding paragraph, emphasizing the matter disclosed in the audited financial statements and the interim financial information. The following is an example of such a paragraph.

> Note 4 of the Company's audited financial statements as of December 31, 20X1, and for the year then ended discloses that the Company was unable to renew its line of credit or obtain alternative financing at December 31, 20X1. Our auditor's report on those financial statements includes an explanatory paragraph referring to the matters in Note 4 of those financial statements and indicating that these matters raised substantial doubt about the Company's ability to continue as a going concern. As indicated in Note 3 of the Company's unaudited interim financial statements as of March 31, 20X2, and for the three months then ended, the Company was still unable to renew its line of credit or obtain alternative financing as of March 31, 20X2. The accompanying interim financial information does not include any adjustments that might result from the outcome of this uncertainty.

.45 *Going-concern paragraph was not included in the prior year's audit report; conditions or events exist as of the interim reporting date covered by the review that might be indicative of the entity's possible inability to continue as a going concern.* If (*a*) conditions or events exist as of the interim reporting date covered by the review that might be indicative of the entity's possible inability to continue as a going concern, and (*b*) there is adequate and appropriate disclosure about these conditions or events in the interim financial information, the accountant is not required to modify his or her report. However, the accountant may add an explanatory paragraph to the review report, after the concluding paragraph, emphasizing the matter disclosed in the interim financial information. The following is an example of such a paragraph.

> As indicated in Note 3, certain conditions indicate that the Company may be unable to continue as a going concern. The accompanying interim financial information does not include any adjustments that might result from the outcome of this uncertainty.

Subsequent Discovery of Facts Existing at the Date of the Accountant's Report

.46 Subsequent to the date of the accountant's review report or the completion of the interim review procedures, if a report is not issued, the accountant may become aware that facts existed at the date of the review report (or the completion of the review procedures) that might have affected the accountant's report (or conclusion, if a report is not issued) had he or she then been aware of those matters. Because of the variety of conditions that might be encountered, the specific actions to be taken by the accountant in a particular case may vary with the circumstances. In any event, the accountant should consider the guidance in section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

Client's Representation Concerning a Review of Interim Financial Information

.47 If a client represents in a document filed with a regulatory agency (see paragraph .03 of this section for the SEC requirement) or issued to stockholders or third parties, that the accountant has reviewed the interim financial information included in the document, the accountant should advise the entity that his or her review report must be included in the document. If the client will not agree to include the accountant's review report, the accountant should perform the following procedures.

- Request that the accountant's name be neither associated with the interim financial information nor referred to in the document.
- If the client does not comply with the request, advise the client that the accountant will not consent either to the use of his or her name or to reference to him or her.
- When appropriate, recommend that the client consult with its legal counsel about the application of relevant laws and regulations to the circumstances.
- Consider what other actions might be appropriate.[33]

.48 If a client represents in a document filed with a regulatory agency (see paragraph .03 of this section for the SEC requirement) or issued to stockholders or third parties that the accountant has reviewed the interim financial information included in the document, and the accountant has been unable to complete the review of the interim financial information, the accountant should refer to paragraph .28 of this section for guidance.

Interim Financial Information Accompanying Audited Financial Statements

.49 Interim financial information may be presented as supplementary information outside audited financial statements. In such circumstances, each page of the interim financial information should be clearly marked as unaudited. If management chooses or is required to present interim financial information in a note to the audited financial statements, the information also should be clearly marked as unaudited.

.50 The auditor ordinarily need not modify his or her report on the audited financial statements to refer to his or her having performed a review in accordance with this section or to refer to the interim financial information accompanying the audited financial statements because the interim financial information has not been audited and is not required for the audited financial statements to be fairly stated in conformity with generally accepted accounting principles. The auditor's report on the audited financial statements should, however, be modified in the following circumstances:

a. The interim financial information included in a note to the financial statements, including information that has been reviewed in accordance with this section, is not appropriately marked as unaudited. (In these circumstances the auditor should disclaim an opinion on the interim financial information.)

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[33] In considering what actions, if any, may be appropriate in these circumstances, the accountant should consider consulting his or her legal counsel.

b. The interim financial information accompanying audited financial statements does not appear to be presented in conformity with generally accepted accounting principles (see paragraphs .42 and .43 of this section). However, the auditor need not modify his or her report on the audited financial statements if his or her separate review report, which refers to those circumstances, is presented with the information.

c. The selected quarterly financial data required by item 302(a) of Regulation S-K is omitted. The following is an example of a paragraph that should be added to the auditor's report if the selected quarterly financial data required by item 302(a) is omitted.

The company has not presented the selected quarterly financial data specified in item 302(a) of Regulation S-K that the Securities and Exchange Commission requires as supplementary information to the basic financial statements.

d. The selected quarterly financial data required by item 302(a) of Regulation S-K has not been reviewed. The following is an example of a paragraph that should be added to the auditor's report if the selected quarterly financial data required by item 302(a) has not been reviewed.

The selected quarterly financial data on page xx contains information that we did not audit, and, accordingly, we do not express an opinion on that data. We attempted but were unable to review the quarterly data in accordance with standards established by the American Institute of Certified Public Accountants because we believe that the company's internal control for the preparation of interim financial information does not provide an adequate basis to enable us to complete such a review.

Documentation

.51 The accountant should prepare documentation in connection with a review of interim financial information, the form and content of which should be designed to meet the circumstances of the particular engagement. Documentation is the principal record of the review procedures performed and the conclusions reached by the accountant in performing the review.[34] Examples of documentation are review programs, analyses, memoranda, and letters of representation. Documentation may be in paper or electronic form, or other media. The quantity, type, and content of the documentation are matters of the accountant's professional judgment.

.52 Because of the different circumstances in individual engagements, it is not possible to specify the form or content of the documentation the accountant should prepare. However, the documentation should include any findings or issues that in the accountant's judgment are significant, for example, the results of review procedures that indicate that the interim financial information could be materially misstated, including actions taken to address such findings, and the basis for the final conclusions reached. In addition, the documentation should (*a*) enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of the review procedures performed; (*b*) identify the engagement team member(s)

[34] However, an accountant would not be precluded from supporting his or her conclusions by other means in addition to the documentation.

who performed and reviewed the work; and (*c*) identify the evidence the accountant obtained in support of the conclusion that the interim financial information being reviewed agreed or reconciled with the accounting records (see paragraph .18(*d*) of this section).

Effective Date

.53 This section is effective for interim periods within fiscal years beginning after December 15, 2002. Earlier application of the provisions of this section is permitted.

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Appendix A

Analytical Procedures the Accountant May Consider Performing When Conducting a Review of Interim Financial Information

A1. Analytical procedures are designed to identify relationships and individual items that appear to be unusual and that may reflect a material misstatement of the interim financial information. These procedures may consist of comparing interim financial information with prior period information, actual interim results with anticipated results (such as budgets or forecasts), and recorded amounts or ratios with expectations developed by the accountant. Examples of analytical procedures an accountant may consider performing in a review of interim financial information include:

- Comparing current interim financial information with anticipated results, such as budgets or forecasts (for example, comparing tax balances and the relationship between the provision for income taxes and pretax income in the current interim financial information with corresponding information in (*a*) budgets, using expected rates, and (*b*) financial information for prior periods).[35]
- Comparing current interim financial information with relevant nonfinancial information.
- Comparing ratios and indicators for the current interim period with expectations based on prior periods, for example, performing gross profit analysis by product line and operating segment using elements of the current interim financial information and comparing the results with corresponding information for prior periods. Examples of key ratios and indicators are the current ratio, receivable turnover or days' sales outstanding, inventory turnover, depreciation to average fixed assets, debt to equity, gross profit percentage, net income percentage, and plant operating rates.
- Comparing ratios and indicators for the current interim period with those of entities in the same industry.
- Comparing relationships among elements in the current interim financial information with corresponding relationships in the interim financial information of prior periods, for example, expense by type as a percentage of sales, assets by type as a percentage of total assets, and percentage of change in sales to percentage of change in receivables.
- Comparing disaggregated data. The following are examples of how data may be disaggregated.
  - — By period, for example, financial statement items disaggregated into quarterly, monthly, or weekly amounts.

[35] The accountant should exercise caution when comparing and evaluating current interim financial information with budgets, forecasts, or other anticipated results because of the inherent lack of precision in estimating the future and susceptibility of such information to manipulation and misstatement by management to reflect desired interim results.

— By product line or operating segment.

— By location, for example, subsidiary, division, or branch.

A2. Analytical procedures may include such statistical techniques as trend analysis or regression analysis and may be performed manually or with the use of computer-assisted techniques.

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Appendix B

Unusual or Complex Situations to Be Considered by the Accountant When Conducting a Review of Interim Financial Information

B1. The following are examples of situations about which the accountant would ordinarily inquire of management:

- Business combinations
- New or complex revenue recognition methods
- Impairment of assets
- Disposal of a segment of a business
- Use of derivative instruments and hedging activities
- Sales and transfers that may call into question the classification of investments in securities, including management's intent and ability with respect to the remaining securities classified as held to maturity
- Computation of earnings per share in a complex capital structure
- Adoption of new stock compensation plans or changes to existing plans
- Restructuring charges taken in the current and prior quarters
- Significant, unusual, or infrequently occurring transactions
- Changes in litigation or contingencies
- Changes in major contracts with customers or suppliers
- Application of new accounting principles
- Changes in accounting principles or the methods of applying them
- Trends and developments affecting accounting estimates,[36] such as allowances for bad debts and excess or obsolete inventories, provisions for warranties and employee benefits, and realization of unearned income and deferred charges
- Compliance with debt covenants
- Changes in related parties or significant new related-party transactions
- Material off-balance-sheet transactions, special-purpose entities, and other equity investments
- Unique terms for debt or capital stock that could affect classification

[36] The accountant may wish to refer to the guidance in section 342, *Auditing Accounting Estimates*, paragraphs .05 and .06.

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Appendix C

Illustrative Management Representation Letters for a Review of Interim Financial Information

[The following paragraph is effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]

C1. The following illustrative management representation letters, which relate to a review of interim financial information prepared in conformity with generally accepted accounting principles, are presented for illustrative purposes only. The first letter is designed to be used in conjunction with the representation letter provided by management in connection with the audit of the financial statements of the prior year. The second illustrative representation letter may be used independently of any other representation letter.

C2. The introductory paragraph of the letters should specify the financial statements and periods covered by the accountant's report, for example, "condensed balance sheets of XYZ Company as of June 30, 20X1 and 20X2, and the related condensed statements of income and retained earnings and cash flows for the three-month and nine-month periods then ended." The written representations to be obtained should be based on the circumstances of the engagement and the nature and basis of presentation of the financial statements being reviewed. Appendix B, "Additional Illustrative Representations," of section 333, *Management Representations*, presents examples of such representations. Illustrative representations for specialized industries are presented in AICPA Audit and Accounting Guides.

C3. If matters exist that should be disclosed to the accountant, they should be indicated by modifying the related representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the interim financial statements, the final paragraph could be modified as follows: "To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred. . . ." In appropriate circumstances, item 10 of the second illustrative representation letter could be modified as follows: "The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except for our plans to dispose of segment A, as disclosed in Note X to the interim financial information, which are discussed in the minutes of the June 7, 20X2, meeting of the board of directors (or disclosed to you at our meeting on June 15, 20X2)." Similarly, if management has received a communication regarding an allegation of fraud or suspected fraud, item 7 of the first illustrative representation letter and item 9 of the second illustrative representation letter could be modified as follows: "Except for the allegation discussed in the minutes of the December 7, 20X1, meeting of the board of directors (or disclosed to you at our meeting on October 15, 20X1), we have no knowledge of any allegations of fraud or suspected fraud affecting the company received in communications from employees, former employees, analysts, regulators, short sellers, or others."

C4. The qualitative discussion of materiality used in the illustrative letters is adapted from the Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*.

C5. Certain terms are used in the illustrative letters that are described elsewhere in authoritative literature. Examples are *fraud*, in section 316, *Consideration of Fraud in a Financial Statement Audit*, and *related parties*, in section 334, *Related Parties*, footnote 1). To avoid misunderstanding concerning the meaning of such terms, the accountant may wish to furnish those definitions to management or request that the definitions be included in the written representations.

C6. The illustrative letters assume that management and the accountant have reached an understanding on the limits of materiality for purposes of the written representations. However, it should be noted that a materiality limit would not apply for certain representations, as explained in section 333.08.

1. Illustrative Short-Form Representation Letter for a Review of Interim Financial Information (Statements)

[*This representation letter is to be used in conjunction with the representation letter for the audit of the financial statements of the prior year. Management confirms the representations made in the representation letter for the audit of the financial statements of the prior year end as they apply to the interim financial information, and makes additional representations that may be needed for the interim financial information.*]

[*Date*]

To [*Independent Accountant*]:

We are providing this letter in connection with your review of the [*identification of interim financial information (statements)*] of [*name of entity*] as of [*dates*] and for the [*periods*] for the purpose of determining whether any material modifications should be made to the [*consolidated*] interim financial information (statements) for it (them) to conform with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation of the [*consolidated*] interim financial information (statements) in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, [*as of* (*date of accountant's report or completion of review*),] the following representations made to you during your review.

1. The interim financial information (statements) referred to above has (have) been prepared and presented in conformity with generally accepted accounting principles applicable to interim financial information.
2. We have made available to you:
    a. All financial records and related data.
    b. All minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. All significant board and committee actions are included in the summaries.

3. We believe that the effects of any uncorrected financial statement misstatements aggregated by you during the current review engagement and pertaining to the interim period(s) in the current year, as summarized in the accompanying schedule, are immaterial, both individually and in the aggregate, to the interim financial information (statements) taken as a whole.[37]
4. There are no significant deficiencies, including material weaknesses, in the design or operation of internal controls which could adversely affect the company's ability to record, process, summarize, and report interim financial data.
5. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
6. We have no knowledge of any fraud or suspected fraud affecting the company involving:
    a. Management;
    b. Employees who have significant roles in internal control; or
    c. Others where the fraud could have a material effect on the interim financial information.
7. We have no knowledge of any allegations of fraud or suspected fraud affecting the company in communications from employees, former employees, analysts, regulators, short sellers, or others.
8. We have reviewed our representation letter to you dated [*date of representation letter relating to most recent audit*] with respect to the audited financial statements for the year ended [*prior year-end date*]. We believe that representations A, B, and C within that representation letter do not apply to the interim financial information (statements) referred to above. We now confirm those representations 1 through X, as they apply to the interim financial information (statements) referred to above, and incorporate them herein, with the following changes:
[*Indicate any changes.*]
9. [*Add any representations related to new accounting or auditing standards that are being implemented for the first time.*]

To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned interim financial information (statements).

_____
[*Name of chief executive officer and title*]

_____
[*Name of chief financial officer and title*]

_____
[*Name of chief accounting officer and title*]

[37] If a summary of uncorrected misstatements is unnecessary because no uncorrected misstatements were identified, this representation should be eliminated.

2. Illustrative Representation Letter for a Review of Interim Financial Information (Statements)

[*This representation letter is similar in detail to the management-representation letter used for the audit of the financial statements of the prior year and thus need not refer to the written management representations received in the most recent audit.*]

[*Date*]

To [*Independent Accountant*]:

We are providing this letter in connection with your review of the [*identification of interim financial information (statements)*] of [*name of entity*] as of [*dates*] and for the [*periods*] for the purpose of determining whether any material modifications should be made to the [*consolidated*] interim financial information (statements) for it (them) to conform with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation of the [*consolidated*] interim financial information (statements) in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, [*as of* (*date of accountant's report or the completion of the review*)], the following representations made to you during your review.

1. The interim financial information (statements) referred to above has (have) been prepared and presented in conformity with generally accepted accounting principles applicable to interim financial information (statements).
2. We have made available to you—
    a. All financial records and related data.
    b. All minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. All significant board and committee actions are included in the summaries.
3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
4. There are no material transactions that have not been properly recorded in the accounting records underlying the interim financial information.
5. We believe that the effects of any uncorrected financial statement misstatements aggregated by you during the current review engagement and pertaining to the interim period(s) in the current year, as summarized in the accompanying schedule, are immaterial, both individually and in

the aggregate, to the interim financial information (statements) taken as a whole. [38]

6. There are no significant deficiencies, including material weaknesses, in the design or operation of internal controls which could adversely affect the company's ability to record, process, summarize, and report interim financial data.
7. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
8. We have no knowledge of any fraud or suspected fraud affecting the company involving:
    a. Management;
    b. Employees who have significant roles in internal control; or
    c. Others where the fraud could have a material effect on the interim financial information.
9. We have no knowledge of any allegations of fraud or suspected fraud affecting the company received in communications from employees, former employees, analysts, regulators, short sellers, or others.
10. The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
11. The following have been properly recorded or disclosed in the interim financial information (statements):
    a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
    b. Guarantees, whether written or oral, under which the company is contingently liable.
    c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. [*Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.*]
12. There are no:
    a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the interim financial information

[38] If a summary of uncorrected misstatements is unnecessary because no uncorrected misstatements were identified, this representation should be eliminated.

(statements) or as a basis for recording a loss contingency.

b. Unasserted claims or assessments that are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.

c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.

13. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets; nor has any asset been pledged as collateral.
14. The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
15. [*Add additional representations that are unique to the entity's business or industry. See paragraph .21 of this section and section 333,* Management Representations, *paragraph .17).*]
16. [*Add any representations related to new accounting or auditing standards that are being implemented for the first time*.]

To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned interim financial information (statements).

_____

[*Name of chief executive officer and title*]

_____

[*Name of chief financial officer and title*]

_____

[*Name of chief accounting officer and title*]

AU Section 800
COMPLIANCE AUDITING

TABLE OF CONTENTS

AU Section 801

Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance

(Supersedes SAS No. 68)

Source: SAS No. 74; SAS No. 75.

Effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after December 31, 1994, unless otherwise indicated.

Introduction and Applicability

.01 This section[1] is applicable when the auditor is engaged to audit a governmental entity under generally accepted auditing standards (GAAS), and engaged to test and report on compliance with laws and regulations under *Government Auditing Standards* (the Yellow Book) or in certain other circumstances involving governmental financial assistance,[2,3] such as single or organization-wide audits or program-specific audits under certain federal or state audit regulations.[4]

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[1] [Footnote deleted to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

[2] Guidance for engagements related to management's written assertion about either (*a*) an entity's compliance with the requirements of specified laws, regulations, rules, or contracts not involving governmental financial assistance, or (*b*) the effectiveness of an entity's internal control structure over compliance with specified requirements is provided in AT section 601, *Compliance Attestation*. [Footnote revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

[3] When engaged to perform an agreed-upon procedures engagement for which the objective is to report in accordance with this section, the auditor may consider the guidance in AT section 201, *Agreed-Upon Procedures Engagements*. [Footnote added, effective for reports on agreed-upon procedures engagements dated after April 30, 1996, by Statement on Auditing Standards No. 75. Footnote revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10.]

[4] A single or organization-wide audit is an audit of an entity's financial statements and of compliance with regulations relating to governmental financial assistance. Examples are audits required by the Single Audit Act of 1984 and Office of Management and Budget (OMB) Circular A-128, *Audits of State and Local Governments*, OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*, or *the Connecticut Single Audit Act*. A program-specific audit is an audit of one governmental financial assistance program in accordance with federal or state laws, regulations or audit guides, such as the U.S. Department of Education's *Student Financial Assistance Audit Guide*, or the U.S. Department of Housing and Urban Development's (HUD's) *Consolidated Audit Guide for Audits of HUD Programs*, relative to that program. An auditor may also be engaged to test and report on compliance with other federal, state, and local laws and regulations that are beyond the scope of this section. (For additional guidance, see footnote 2.) [Footnote renumbered by the issuance of Statement on Auditing Standards No. 75, September 1995.]

.02 Specifically, this section provides general[5] guidance to the auditor to—

a. Apply the provisions of section 317, *Illegal Acts by Clients*, relative to detecting misstatements resulting from illegal acts related to laws and regulations that have a direct and material effect on the determination of financial statement amounts in audits of the financial statements of governmental entities and other recipients of governmental financial assistance (paragraphs .03 through .07).

b. Perform a financial audit in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States (paragraphs .08 and .09).[6]

c. Perform a single or organization-wide audit or a program-specific audit in accordance with federal audit requirements (paragraphs .10 through .20).

d. Communicate with management if the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of his or her engagement (paragraphs .21 through .23).

Effects of Laws on Financial Statements

.03 The Governmental Accounting Standards Board's (GASB's) *Codification of Governmental Accounting and Financial Reporting Standards*, section 1200.103, recognizes that governmental entities generally are subject to a variety of laws and regulations that affect their financial statements.

> An important aspect of GAAP [generally accepted accounting principles] as applied to governments is the recognition of the variety of legal and contractual considerations typical of the government environment. These considerations underlie and are reflected in the fund structure, bases of accounting, and other principles and methods set forth here, and are a major factor distinguishing governmental accounting from commercial accounting.

For example, such laws and regulations may address the fund structure required by law, regulation, or bond covenant; procurement; debt limitations; and legal authority for transactions.

.04 Federal, state, and local governmental entities provide financial assistance to other entities, including not-for-profit organizations and business enterprises that are either primary recipients, subrecipients,[7] or beneficiaries. Among the forms of governmental financial assistance are grants of cash and

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[5] Specific guidance is provided in the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, and in Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 75, September 1995.]

[6] In practice, *Government Auditing Standards*, or the Yellow Book, is sometimes referred to as *generally accepted government auditing standards* (GAGAS). *Government Auditing Standards* includes standards for financial and performance audits. The references to *Government Auditing Standards* in this section encompass only the standards that apply to financial audits, not the performance audit standards. The auditor should be aware that *Government Auditing Standards* is revised periodically and should ensure that the currently effective version is being followed. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 75, September 1995.]

[7] A subrecipient is an entity that receives governmental financial assistance when the assistance is initially received by another entity (the primary recipient) that distributes the assistance for the government program that created and provided the assistance. As used in this section, *recipient* means either a primary recipient or a subrecipient. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 75, September 1995.]

other assets, loans, loan guarantees, and interest-rate subsidies.[8] By accepting such assistance, both governmental and nongovernmental entities may be subject to laws and regulations that may have a direct and material effect on the determination of amounts in their financial statements.

.05 Management is responsible for ensuring that the entity complies with the laws and regulations applicable to its activities. That responsibility encompasses the identification of applicable laws and regulations and the establishment of controls designed to provide reasonable assurance that the entity complies with those laws and regulations. The auditor's responsibility for testing and reporting on compliance with laws and regulations varies according to the terms of the engagement.

.06 Section 317 describes the auditor's responsibility, in an audit performed in accordance with GAAS, for considering laws and regulations and how they affect the audit. Thus, the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.

.07 The auditor should obtain an understanding of the possible effects on financial statements of laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of amounts in an entity's financial statements. The auditor should also assess whether management has identified laws and regulations that have a direct and material effect on the determination of amounts in the entity's financial statements and obtain an understanding of the possible effects on the financial statements of such laws and regulations. The auditor may consider performing the following procedures in assessing such laws and regulations and in obtaining an understanding of their possible effects on the financial statements.

a. Consider knowledge about such laws and regulations obtained from prior years' audits.

b. Discuss such laws and regulations with the entity's chief financial officer, legal counsel, or grant administrators.

c. Obtain written representation from management regarding the completeness of management's identification.

d. Review the relevant portions of any directly related agreements, such as those related to grants and loans.

e. Review the minutes of meetings of the legislative body and governing board of the governmental entity being audited for the enactment of laws and regulations that have a direct and material effect on the determination of amounts in the governmental entity's financial statements.

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[8] For purposes of this section, financial assistance, as defined by the Single Audit Act of 1984 and OMB Circular A-128, does not include contracts to provide goods or services to a governmental entity or arrangements in which a nongovernmental entity purchases insurance from the government. Federal awards, as defined by OMB Circular A-133, means financial assistance and federal cost-type contracts used to buy services or goods for the use of the federal government. Federal awards do not include procurement contracts to vendors under grants or contracts used to buy goods or services. For example, financial assistance does not include a contract to design and manufacture aircraft for the U.S. Air Force or the purchase of deposit insurance by a financial institution. In addition, although Medicaid funds paid by the federal government to states constitute financial assistance, most Medicaid arrangements between the states and health-care providers are contracts for services that are not considered to be financial assistance. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 75, September 1995.]

f. Inquire of the office of the federal, state, or local auditor, or other appropriate audit oversight organization about the laws and regulations applicable to entities within their jurisdiction, including statutes and uniform reporting requirements.

g. Review information about compliance requirements, such as the information included in the Compliance Supplements issued by OMB: *Compliance Supplement for Single Audits of State and Local Governments* and *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions, Catalog of Federal Domestic Assistance*, issued by the Government Printing Office, and state and local policies and procedures.

Government Auditing Standards

.08 *Government Auditing Standards* contains standards for audits of government organizations, programs, activities, and functions and of government assistance received by contractors, not-for-profit organizations, and other nongovernment organizations. These standards, which include designing the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts, are to be followed when required by law, regulation, agreement, contract, or policy.[9]

.09 For financial audits, *Government Auditing Standards* prescribes fieldwork and reporting standards beyond those required by GAAS. The general standards of *Government Auditing Standards* relate to qualifications of the staff, independence, due professional care, and quality control.

Federal Audit Requirements

.10 Although the scope and reporting requirements of an audit of a recipient of federal financial assistance in accordance with federal audit regulations vary, the audits generally have the following elements in common.

a. The audit is to be conducted in accordance with GAAS and *Government Auditing Standards*.

b. The auditor's consideration of internal control is to include obtaining and documenting an understanding of internal control established to ensure compliance with the laws and regulations applicable to the federal financial assistance. In some instances, federal audit regulations mandate a "test of controls" to evaluate the effectiveness of the design and operation of the policies and procedures in preventing or detecting material noncompliance.

c. The auditor is to issue a report on the consideration of internal control described above.

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[9] Some states have adopted regulations that require local governments within the states to have their audits conducted in accordance with *Government Auditing Standards*. In addition, some states require that recipients of state financial assistance be audited in accordance with *Government Auditing Standards*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 75, September 1995.]

d. The auditor is to determine and report on whether the federal financial assistance has been administered in accordance with applicable laws and regulations (that is, compliance requirements).[10]

.11 A recipient of federal financial assistance may be subject to a single or organization-wide audit or to a program-specific audit. A number of federal audit regulations permit the recipient to "elect" to have a program-specific audit, whereas other federal audit regulations require a program-specific audit in certain circumstances. In planning the audit, the auditor should determine and consider the specific federal audit requirements[11] applicable to the engagement, including the issuance of additional reports. As noted in paragraph .10 of this section, federal audit regulations for both single or organization-wide audits and program-specific audits generally require consideration of internal control beyond what is normally required by GAAS and *Government Auditing Standards* and a determination of whether applicable compliance requirements have been met.

Compliance Requirements Applicable to Federal Financial Assistance Programs

.12 Compliance requirements applicable to federal financial assistance programs are usually one of two types: general and specific. General requirements involve national policy and apply to all or most federal financial assistance programs.[12]

.13 Specific requirements apply to a particular federal program and generally arise from statutory requirements and regulations. The OMB's Compliance Supplements set forth general and specific requirements for many of the federal programs awarded to state and local governments and to not-for-profit organizations, as well as suggested audit procedures to test for compliance with the requirements.

.14 For program-specific audits, the auditor should consult federal grantor agency audit guides to identify general requirements that are statutory and regulatory requirements pertaining to certain federal programs, specific requirements for a particular program, and suggested audit procedures to test for compliance with the requirements.

.15 In addition to those identified in the OMB's Compliance Supplements or federal grantor agency audit guides, specific requirements may also be enumerated in grant agreements or contracts.

.16 Generally, the auditor is required to determine whether the recipient has complied with the general and specific requirements. The form of the report and the required level of assurance to be provided in the report may vary, depending on the requirements of a particular agency or program. For example, if reporting on compliance requirements, the auditor may be required to report

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[10] [Footnote renumbered by the issuance of Statement on Auditing Standards No. 75, September 1995. Footnote deleted to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 85.]

[11] Such requirements may be set out in an engagement letter or audit contract. In some instances, a written engagement letter is required by the federal grantor agency. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 75, September 1995.]

[12] General requirements also may be referred to as *common* requirements. Detailed guidance on evaluating the results of testing general requirements can be found in the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, and in SOP 92-9. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 75, September 1995.]

findings relating to compliance with those requirements or the auditor may be required to express an opinion on whether the recipient has complied with the requirements applicable to its major[13] federal financial assistance programs.[14]

Evaluating Results of Compliance Audit Procedures on Major Federal Financial Assistance Programs

.17 In evaluating whether an entity has complied with laws and regulations that, if not complied with, could have a material effect on each major federal financial assistance program, the auditor should consider the effect of identified instances of noncompliance on each such program. In doing so, the auditor should consider—

a. The frequency of noncompliance identified in the audit.

b. The adequacy of a primary recipient's system for monitoring subrecipients and the possible effect on the program of any noncompliance identified by the primary recipient or the auditors of the subrecipients.

c. Whether any instances of noncompliance identified in the audit resulted in questioned costs, as discussed below, and, if they did, whether questioned costs are material to the program.[15]

.18 The criteria for classifying a cost as a questioned cost vary from one federal agency to another. In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of total costs questioned for each major federal financial assistance program (hereafter referred to as *likely questioned costs*), not just the questioned costs specifically identified (hereafter referred to as *known questioned costs*). When using audit sampling, as defined in section 350, *Audit Sampling*, in testing compliance, the auditor should project the amount of known questioned costs identified in the sample to the items in the major federal financial assistance program from which the sample was selected.

.19 Regardless of the auditor's opinion on compliance, federal audit regulations may require him or her to report any instances of noncompliance found and any resulting questioned costs. In reporting instances of noncompliance, the auditor should follow the provisions of *Government Auditing Standards*. For purposes of reporting questioned costs, the auditor is not required to report likely questioned costs; rather, the auditor should report only known questioned costs.

.20 When evaluating the results of compliance audit procedures on federal financial assistance programs, the auditor also should consider whether identified instances of noncompliance affect his or her opinion on the entity's financial statements (see paragraph .06).

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[13] A major federal financial assistance program is defined by a federal regulation or law or by the federal grantor agency's audit guide. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 75, September 1995.]

[14] Detailed testing and reporting guidance on single or organization-wide audits and program-specific audits is provided in the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units and in* SOP 92-9. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 75, September 1995.]

[15] In auditing compliance with requirements governing major federal financial assistance programs, the auditor's consideration of materiality differs from that in an audit of the financial statements in accordance with GAAS. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 75, September 1995.]

Communications Regarding Applicable Audit Requirements

.21 Management is responsible for obtaining audits that satisfy relevant legal, regulatory, or contractual requirements. Auditors should exercise due professional care in ensuring that they and management understand the type of engagement to be performed. If a proposal, contract, or engagement letter is used, an auditor should consider including in it a statement about the type of engagement and whether the engagement is intended to meet specific audit requirements.

.22 GAAS do not require the auditor to perform procedures beyond those he or she considers necessary to obtain sufficient competent evidential matter to form a basis for the opinion on the financial statements. However, if during a GAAS audit of the financial statements the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements.[16] For example, the auditor will be required to make this communication if an entity engages an auditor to perform an audit of its financial statements in accordance with GAAS and the auditor becomes aware that by law, regulation, or contractual agreement the entity also is required to have an audit performed in accordance with one or more of the following:

a. *Government Auditing Standards*

b. The Single Audit Act of 1984 and OMB Circular A-128, *Audits of State and Local Governments*

c. OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*

d. Other compliance audit requirements, such as state or local laws or program-specific audits under federal audit guides

.23 The communication required by paragraph .22 of this section may be oral or written. If the communication is oral, the auditor should document the communication in the working papers. The auditor should consider how the client's actions in response to such communication relate to other aspects of the audit, including the potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in section 317.

Effective Date

.24 The provisions of this section are effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after December 31, 1994. Early application of this section is encouraged.

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[16] For entities that do not have an audit committee, "others with equivalent authority or responsibility" may include the board of directors, the board of trustees, the owner in owner-managed entities, the city council, or the legislative standing committee. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 75, September 1995.]

AU Section 900

SPECIAL REPORTS OF THE COMMITTEE ON AUDITING PROCEDURE

TABLE OF CONTENTS

AU Section 901

Public Warehouses—Controls and Auditing Procedure for Goods Held[*]

Source: SAS No. 1, section 901; SAS No. 43.

Issue date, unless otherwise indicated: November, 1972.

Introduction

.01 This section discusses controls of a public warehouse, the procedures of its independent auditor with respect to goods in the warehouse's custody, and auditing procedures performed by the independent auditor of the owner of goods in the warehouse.[1] [As amended, effective after August 31, 1982, by Statement on Auditing Standards No. 43.]

General Considerations

.02 The management of a business has the responsibility for the proper recording of transactions in its books of account, for the safeguarding of its assets, and for the substantial accuracy and adequacy of its financial statements. The independent auditor is not an insurer or guarantor; his responsibility is to express a professional opinion on the financial statements he has audited.[2] [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

Summary of Recommendations

.03 The Committee recommends that the independent auditor of the warehouseman:

a. Obtain an understanding of controls, relating to the accountability for and the custody of all goods placed in the warehouse and perform tests of controls to evaluate their effectiveness.

b. Test the warehouseman's records relating to accountability for all goods placed in his custody.

c. Test the warehouseman's accountability under recorded outstanding warehouse receipts.

d. Observe physical counts of the goods in custody, wherever practicable and reasonable, and reconcile his tests of such counts with records of goods stored.

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[*] Title revised, February 1997, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 78.

[1] This section reports the conclusions of a 1966 study of the AICPA Committee on Auditing Procedure on the accountability of warehousemen for goods stored in public warehouses. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

[2] See section 110.

e. Confirm accountability (to the extent considered necessary) by direct communication with the holders of warehouse receipts.

The independent auditor should apply such other procedures as he considers necessary in the circumstances. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 48, July 1984.]

.04 Warehousing activities are diverse because the warehoused goods are diverse, the purposes of placing goods in custody are varied, and the scope of operations of warehouses is not uniform. The independent auditor has the responsibility to exercise his judgment in determining what procedures, including those recommended in this report, are necessary in the circumstances to afford a reasonable basis for his opinion on the financial statements.[3] [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

.05 The following sections of this report describe those aspects of warehousing operations of primary concern to independent auditors, suggest elements of internal control for warehousemen, and offer the Committee's recommendations as to procedures of the independent auditor. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

Public Warehouse Operations

Types of Warehouses

.06 A warehouse may be described as a facility operated by a warehouseman whose business is the maintaining of effective custody of goods for others. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

.07 Warehouses may be classified functionally as terminal warehouses or field warehouses:

Terminal Warehouse. The principal economic function of a terminal warehouse is to furnish storage. It may, however, perform other functions, including packaging and billing. It may be used to store a wide variety of goods or only a particular type of commodity.

Field Warehouse. A field warehouse is established in space leased by the warehouseman on the premises of the owner of the goods or the premises of a customer of the owner. In most circumstances all or most of the personnel at the warehouse location are employed by the warehouseman from among the employees of the owner (or customer), usually from among those who previously have been responsible for custody and handling of the goods. Field warehousing is essentially a financing arrangement, rather than a storage operation. The warehouse is established to permit the warehouseman to take and maintain custody of goods and issue warehouse receipts to be used as collateral for a loan or other form of credit.

Warehouses may be classified also by types of goods stored. Foods and other perishable products may be stored in refrigerated warehouses, constructed and equipped to meet controlled temperature and special handling requirements.

[3] See section 326.

Certain bulk commodities, such as various agricultural products and chemicals, are stored in commodity warehouses; these warehouses often are designed and equipped to store only one commodity, and fungible goods frequently are commingled without regard to ownership. A wide variety of goods, usually not requiring special storage facilities, is stored in general merchandise warehouses. Some warehouses confine their activities to storing furniture, other household goods, and personal effects. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

Warehouse Receipts

.08 A basic document in warehousing is the warehouse receipt. Article 7 of the Uniform Commercial Code regulates the issuance of warehouse receipts, prescribes certain terms that must be contained in such receipts, provides for their negotiation and transfer, and establishes the rights of receipt holders. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

.09 Warehouse receipts may be in negotiable form or non-negotiable form and may be used as evidence of collateral for loans or other forms of credit. Goods represented by a negotiable warehouse receipt may be released only upon surrender of the receipt to the warehouseman for cancellation or endorsement, whereas goods represented by a non-negotiable receipt may be released upon valid instructions without the need for surrender of the receipt. Other important ways in which the two kinds of receipts differ concern the manner in which the right of possession to the goods they represent may be transferred from one party to another and the rights acquired by bona fide purchasers of the receipts. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

.10 Since goods covered by non-negotiable receipts may be released without surrender of the receipts, such outstanding receipts are not necessarily an indication of accountability on the part of the warehouseman or of evidence of ownership by the depositor. Since goods are frequently withdrawn piecemeal, the warehouseman's accountability at any given time is for the quantity of goods for which receipts have been issued minus the quantities released against properly authorized withdrawals. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

.11 Article 7 of the Uniform Commercial Code, in addition to provisions with respect to the issuance and contents of warehouse receipts, contains provisions with respect to, among other things, the storage and release of warehoused goods, the standard of care to be exercised by the warehouseman, warehouseman's liability, and liens for the warehouseman's charges and expenses and the manner in which they may be enforced. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

Government Regulation

.12 There are various other statutes and regulations, applicable in special situations, relating to the rights and duties of warehousemen and the operation of warehouses. Among the more important are (*a*) the United States Warehouse Act and the regulations adopted thereunder by the Department of Agriculture, providing for licensing and regulation of warehouses storing certain agricultural commodities, (*b*) the regulations adopted by commodity exchanges licensed under the United States Commodity Exchange Act, providing for issuance and registration of receipts and licensing and regulation of warehouses,

and (*c*) the Internal Revenue Code and the Tariff Act of 1930, and regulations adopted thereunder, relating respectively to United States Revenue Bonded Warehouses and United States Customs Bonded Warehouses, providing for licensing, bonding, and regulation of such warehouses. In addition, there are statutes and regulations in various states relating to licensing, bonding, insurance, and other matters. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

The Warehouseman

Controls

.13 Goods held in custody for others are not owned by the warehouseman and, therefore, do not appear as assets in his financial statements. Similarly, the related custodial responsibility does not appear as a liability. However, as in other businesses, the warehouseman is exposed to the risk of loss or claims for damage stemming from faulty performance of his operating functions. Faulty performance may take the form of loss or improper release of goods, improper issuance of warehouse receipts, failure to maintain effective custody of goods so that lenders' preferential liens are lost, and other forms. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

.14 The recommendation herein that the independent auditor of the warehouseman obtain an understanding of relevant controls and perform tests of controls to evaluate their effectiveness is based upon the important relationship of such controls to the custodial responsibilities of the warehouseman, which are not reflected in his financial statements. Significant unrecorded liabilities may arise if these custodial responsibilities are not discharged properly. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982. Revised, April 1989, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62.]

.15 Whether and to what extent the suggested controls that follow may be applicable to a particular warehouse operation will depend on the nature of the operation, of the goods stored, and of the warehouseman's organization. Appropriate segregation of duties in the performance of the respective operating functions should be emphasized.

Receiving, Storing, and Delivering Goods

Receipts should be issued for all goods admitted into storage.

Receiving clerks should prepare reports as to all goods received. The receiving report should be compared with quantities shown on bills of lading or other documents received from the owner or other outside sources by an employee independent of receiving, storing, and shipping.

Goods received should be inspected, counted, weighed, measured, or graded in accordance with applicable requirements. There should be a periodic check of the accuracy of any mechanical facilities used for these purposes.

Unless commingling is unavoidable, such as with fungible goods, goods should be stored so that each lot is segregated and identified with the pertinent warehouse receipt. The warehouse office records should show the location of the goods represented by each outstanding receipt.

Instructions should be issued that goods may be released only on proper authorization which, in the case of negotiable receipts, includes surrender of the receipt.

Access to the storage area should be limited to those employees whose duties require it, and the custody of keys should be controlled.

Periodic statements to customers should identify the goods held and request that discrepancies be reported to a specified employee who is not connected with receiving, storing, and delivery of goods.

The stored goods should be physically counted or tested periodically, and quantities agreed to the records by an employee independent of the storage function; the extent to which this is done may depend on the nature of the goods, the rate of turnover, and the effectiveness of other internal control structure policies and procedures.

Where the goods held are perishable, a regular schedule for inspection of condition should be established.

Protective devices such as burglar alarms, fire alarms, sprinkler systems, and temperature and humidity controls should be inspected regularly.

Goods should be released from the warehouse only on the basis of written instructions received from an authorized employee who does not have access to the goods.

Counts of goods released as made by stock clerks should be independently checked by shipping clerks or others and the two counts should be compared before the goods are released.

Warehouse Receipts

Prenumbered receipt forms should be used, and procedures established for accounting for all forms used and for cancellation of negotiable receipts when goods have been delivered.

Unused forms should be safeguarded against theft or misuse and their custody assigned to a responsible employee who is not authorized to prepare or sign receipts.

Receipt forms should be furnished only to authorized persons, and in a quantity limited to the number required for current use.

The signer of receipts should ascertain that the receipts are supported by receiving records or other underlying documents.

Receipts should be prepared and completed in a manner designed to prevent alteration.

Authorized signers should be a limited number of responsible employees.

Insurance

The adequacy, as to both type and amount, of insurance coverage carried by the warehouseman should be reviewed at appropriate intervals.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

Additional Controls for Field Warehouses

.16 As indicated earlier, the purpose of field warehousing differs from terminal warehousing. Operating requirements also may differ because a field warehouseman may operate at a large number of locations. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

.17 In field warehousing, controls are applied at two points: the field location and the warehouseman's central office. At the field location, the controls as to receipt, storage, and delivery of goods and issuance of warehouse receipts generally will comprise the controls suggested above, with such variations as may be appropriate in light of the requirements, and available personnel, at the respective locations. Only non-negotiable warehouse receipts should be issued from field locations, and the receipt forms should be furnished to the field locations by the central office in quantities limited to current requirements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

.18 The central office should investigate and approve the field warehousing arrangements, and exercise control as to custody and release of goods and issuance of receipts at the field locations. Controls suggested for the central office are the following:

Consideration of the business reputation and financial standing of the depositor.

Preparation of a field warehouse contract in accordance with the particular requirements of the depositor and the lender.

Determination that the leased warehouse premises meet the physical requirements for segregation and effective custody of goods.

Satisfaction as to legal matters relative to the lease of the warehouse premises.

Investigation and bonding of the employees at the field locations.

Providing employees at field locations with written instructions covering their duties and responsibilities.

Maintenance of inventory records at the central office showing the quantity (and stated value, where applicable) of goods represented by each outstanding warehouse receipt.

Examination of the field warehouse by representatives of the central office. These examinations would include inspection of the facilities, observation as to adherence to prescribed procedures, physical counts or tests of goods in custody and reconcilement of quantities to records at the central office and at field locations, accounting for all receipt forms furnished to the field locations, and confirmation (on a test basis, where appropriate) of outstanding warehouse receipts with the registered holders.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

Procedures of the Independent Auditor

.19 The Committee recommends that the independent auditor of the warehouseman:

a. Obtain an understanding of controls, relating to the accountability for and the custody of all goods placed in the warehouse and perform tests of controls to evaluate their effectiveness.

b. Test the warehouseman's records relating to accountability for all goods placed in his custody.

c. Test the warehouseman's accountability under recorded outstanding warehouse receipts.

d. Observe physical counts of the goods in custody, wherever practicable and reasonable, and reconcile his tests of such counts with records of goods stored.

e. Confirm accountability (to the extent considered necessary) by direct communication with the holders of warehouse receipts.

The independent auditor should apply such other procedures as he considers necessary in the circumstances. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

.20 The auditor's procedures relating to accountability might include, on a test basis, comparison of documentary evidence of goods received and delivered with warehouse receipts records, accounting for issued and unissued warehouse receipts by number, and comparison of the records of goods stored with billings for storage. In some circumstances, the auditor may consider it necessary to obtain confirmation from the printer as to the serial numbers of receipt forms supplied. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

.21 In the case of a field warehouseman where goods are stored at many scattered locations, the independent auditor may satisfy himself that the warehouseman's physical count procedures are adequate by observing the procedures at certain selected locations. The amount of testing required will be dependent upon the effectiveness of both design and operation of controls. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

.22 The confirmation of negotiable receipts with holders may be impracticable, since the identity of the holders usually is not known to the warehouseman. Confirmation with the depositor to whom the outstanding receipt was originally issued, however, would be evidential matter of the accountability for certain designated goods. It should be recognized, too, that as to both negotiable and non-negotiable receipts, confirmation may not be conclusive in the light of the possibility of issued but unrecorded receipts. In some circumstances, it may be desirable to request confirmations from former depositors who are not currently holders of record. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

.23 The independent auditor should review the nature and extent of the warehouseman's insurance coverage and the adequacy of any reserves for losses under damage claims. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

Controls and Auditing Procedures for Owner's Goods Stored in Public Warehouses

.24 The following paragraphs provide guidance on the controls for the owner of the goods and on the auditing procedures to be employed by his independent auditor. [As amended, effective after August 31, 1982, by Statement on Auditing Standards No. 43.]

Controls

.25 The controls of the owner should be designed to provide reasonable safeguards over his goods in a warehouseman's custody. Ordinarily, the controls should include an investigation of the warehouseman before the goods are placed in custody, and a continuing evaluation of the warehouseman's performance in maintaining custody of the goods. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

.26 Among the suggested controls that may be comprehended in an investigation of the warehouseman before the goods are placed in his custody are the following:

Consideration of the business reputation and financial standing of the warehouseman.

Inspection of the physical facilities.

Inquiries as to the warehouseman's controls and whether the warehouseman holds goods for his own account.

Inquiries as to type and adequacy of the warehouseman's insurance.

Inquiries as to government or other licensing and bonding requirements and the nature, extent, and results of any inspection by government or other agencies.

Review of the warehouseman's financial statements and related reports of independent auditors.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

.27 After the goods are placed in the warehouse, suggested controls that may be applied periodically by the owner in evaluating the warehouseman's performance in maintaining custody of goods include the following:

Review and update the information developed from the investigation described above.

Physical counts (or test counts) of the goods, wherever practicable and reasonable (may not be practicable in the case of fungible goods).

Reconcilement of quantities shown on statements received from the warehouseman with the owner's records.

In addition, he should review his own insurance, if any, on goods in the custody of the warehouseman.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 43, August 1982.]

Procedures of the Independent Auditor

.28 Section 331.14 describes the procedures that the auditor should apply if inventories are held in public warehouses. [As amended, effective after August 31, 1982, by Statement on Auditing Standards No. 43.]

AU TOPICAL INDEX

References are to AU section and paragraph numbers.
Section numbers in the 9000 series refer to interpretations.

A

B

D

G

H

I

L

M

O

Q

R

S

T

ATTESTATION STANDARDS

Introduction

The accompanying "attestation standards" provide guidance and establish a broad framework for a variety of attest services increasingly demanded of the accounting profession. The standards and related interpretive commentary are designed to provide professional guidelines that will enhance both consistency and quality in the performance of such services.

For years, attest services generally were limited to expressing a positive opinion on historical financial statements on the basis of an audit in accordance with generally accepted auditing standards (GAAS). However, certified public accountants increasingly have been requested to provide, and have been providing, assurance on representations other than historical financial statements and in forms other than the positive opinion. In responding to these needs, certified public accountants have been able to generally apply the basic concepts underlying GAAS to these attest services. As the range of attest services has grown, however, it has become increasingly difficult to do so.

Consequently, the main objective of adopting these attestation standards and the related interpretive commentary is to provide a general framework for and set reasonable boundaries around the attest function. As such, the standards and commentary (*a*) provide useful and necessary guidance to certified public accountants engaged to perform new and evolving attest services and (*b*) guide AICPA standard-setting bodies in establishing, if deemed necessary, interpretive standards for such services.

The attestation standards are a natural extension of the ten generally accepted auditing standards. Like the auditing standards, the attestation standards deal with the need for technical competence, independence in mental attitude, due professional care, adequate planning and supervision, sufficient evidence, and appropriate reporting; however, they are much broader in scope. (The eleven attestation standards are listed below.) Such standards apply to a growing array of attest services. These services include, for example, reports on descriptions of systems of internal control; on descriptions of computer software; on compliance with statutory, regulatory, and contractual requirements; on investment performance statistics; and on information supplementary to financial statements. Thus, the standards have been developed to be responsive to a changing environment and the demands of society.

These attestation standards apply only to attest services rendered by a certified public accountant in the practice of public accounting—that is, a practitioner as defined in footnote 1 of paragraph .01.

The attestation standards do not supersede any of the existing standards in Statements on Auditing Standards (SASs), Statements on Standards for Accounting and Review Services (SSARSs), and Statement on Standards for Accountants' Services on Prospective Financial Information. Therefore, the practitioner who is engaged to perform an engagement subject to these existing standards should follow such standards.

Attestation Standards

General Standards

1. The engagement shall be performed by a practitioner having adequate technical training and proficiency in the attest function.
2. The engagement shall be performed by a practitioner having adequate knowledge of the subject matter.
3. The practitioner shall perform the engagement only if he or she has reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users.
4. In all matters relating to the engagement, an independence in mental attitude shall be maintained by the practitioner.
5. Due professional care shall be exercised in the planning and performance of the engagement.

Standards of Fieldwork

1. The work shall be adequately planned and assistants, if any, shall be properly supervised.
2. Sufficient evidence shall be obtained to provide a reasonable basis for the conclusion that is expressed in the report.

Standards of Reporting

1. The report shall identify the subject matter or the assertion being reported on and state the character of the engagement.
2. The report shall state the practitioner's conclusion about the subject matter or the assertion in relation to the criteria against which the subject matter was evaluated.
3. The report shall state all of the practitioner's significant reservations about the engagement, the subject matter, and, if applicable, the assertion related thereto.
4. The report shall state that the use of the report is restricted to specified parties under the following circumstances:
   - When the criteria used to evaluate the subject matter are determined by the practitioner to be appropriate only for a limited number of parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria
   - When the criteria used to evaluate the subject matter are available only to specified parties
   - When reporting on subject matter and a written assertion has not been provided by the responsible party
   - When the report is on an attest engagement to apply agreed-upon procedures to the subject matter.

[As amended, effective for attest reports issued on or after June 30, 1999, by Statement on Standards for Attestation Engagements No. 9. As amended, effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001, by Statement on Standards for Attestation Engagements No. 10.]

AT

STATEMENTS ON STANDARDS FOR ATTESTATION ENGAGEMENTS

TABLE OF CONTENTS

AT Section 101

Attest Engagements

Source: SSAE No. 10; SSAE No. 11; SSAE No. 12; Auditing Standard No. 4.

See section 9101 for interpretations of this section.

Effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001, unless otherwise indicated.

Applicability

.01 This section applies to engagements, except for those services discussed in paragraph .04, in which a certified public accountant in the practice of public accounting[1] (hereinafter referred to as a *practitioner*) is engaged to issue or does issue an examination, a review, or an agreed-upon procedures report on subject matter, or an assertion about the subject matter (hereafter referred to as *the assertion*), that is the responsibility of another party.[2]

.02 This section establishes a framework for attest[3] engagements performed by practitioners and for the ongoing development of related standards. For certain subject matter, specific attestation standards have been developed to provide additional requirements for engagement performance and reporting.

.03 When a practitioner undertakes an attest engagement for the benefit of a government body or agency and agrees to follow specified government standards, guides, procedures, statutes, rules, and regulations, the practitioner is obliged to follow those governmental requirements as well as the applicable attestation standards.

.04 Professional services provided by practitioners that are not covered by this SSAE include the following:

a. Services performed in accordance with Statements on Auditing Standards (SASs)

b. Services performed in accordance with Statements on Standards for Accounting and Review Services (SSARSs)

c. Services performed in accordance with the Statement on Standards for Consulting Services (SSCS), such as engagements in which the practitioner's role is solely to assist the client (for example, acting as the company accountant in preparing information other than financial statements), or engagements in which a

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[1] For a definition of the term *practice of public accounting*, see *Definitions* [ET section 92.25].

[2] See section 301, *Financial Forecasts and Projections*, paragraph .02, for additional guidance on applicability when engaged to provide an attest service on a financial forecast or projection.

[3] The term *attest* and its variants, such as *attesting* and *attestation,* are used in a number of state accountancy laws, and in regulations issued by state boards of accountancy under such laws, for different purposes and with different meanings from those intended by this section. Consequently, the definition of *attest engagements* set out in paragraph .01, and the attendant meaning of *attest* and *attestation* as used throughout the section, should not be understood as defining these terms and similar terms, as they are used in any law or regulation, nor as embodying a common understanding of the terms which may also be reflected in such laws or regulations.

practitioner is engaged to testify as an expert witness in accounting, auditing, taxation, or other matters, given certain stipulated facts

d. Engagements in which the practitioner is engaged to advocate a client's position—for example, tax matters being reviewed by the Internal Revenue Service

e. Tax engagements in which a practitioner is engaged to prepare tax returns or provide tax advice

[*The following item f is added effective February 6, 2006 due to issuance of PCAOB Auditing Standard No. 4, Reporting on Whether a Previously Recorded Material Weakness Continues to Exist. See PCAOB Release No. 2005-015.*]

f. Engagements in which the practitioner is engaged to report on whether a material weakness in internal control over financial reporting continues to exist for any purpose other than the company's internal use. Such engagements must be conducted pursuant to PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*.

.05 An attest engagement may be part of a larger engagement, for example, a feasibility study or business acquisition study may also include an examination of prospective financial information. In such circumstances, these standards apply only to the attest portion of the engagement.

.06 Any professional service resulting in the expression of assurance must be performed under AICPA professional standards that provide for the expression of such assurance. Reports issued by a practitioner in connection with other professional standards should be written to be clearly distinguishable from and not to be confused with attest reports. For example, a practitioner performing an engagement which is intended solely to assist an organization in improving its controls over the privacy of client data should not issue a report as a result of that engagement expressing assurance as to the effectiveness of such controls. Additionally, a report that merely excludes the words, " ...was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants..." but is otherwise similar to an examination, a review or an agreed-upon procedures attest report may be inferred to be an attest report.

Definitions and Underlying Concepts

Subject Matter

.07 The subject matter of an attest engagement may take many forms, including the following:

a. Historical or prospective performance or condition (for example, historical or prospective financial information, performance measurements, and backlog data)

b. Physical characteristics (for example, narrative descriptions, square footage of facilities)

c. Historical events (for example, the price of a market basket of goods on a certain date)

d. Analyses (for example, break-even analyses)

e. Systems and processes (for example, internal control)

f. Behavior (for example, corporate governance, compliance with laws and regulations, and human resource practices)

The subject matter may be as of a point in time or for a period of time.

Assertion

.08 An assertion is any declaration or set of declarations about whether the subject matter is based on or in conformity with the criteria selected.

.09 A practitioner may report on a written assertion or may report directly on the subject matter. In either case, the practitioner should ordinarily obtain a written assertion in an examination or a review engagement. A written assertion may be presented to a practitioner in a number of ways, such as in a narrative description, within a schedule, or as part of a representation letter appropriately identifying what is being presented and the point in time or period of time covered.

.10 When a written assertion has not been obtained, a practitioner may still report on the subject matter; however, the form of the report will vary depending on the circumstances and its use should be restricted.[4] In this section, see paragraphs .58 and .60 on gathering sufficient evidence and paragraphs .73 to .75 and .78 to .80 for reporting guidance.

Responsible Party

.11 The *responsible party* is defined as the person or persons, either as individuals or representatives of the entity, responsible for the subject matter. If the nature of the subject matter is such that no such party exists, a party who has a reasonable basis for making a written assertion about the subject matter may provide such an assertion (hereinafter referred to as the *responsible party*).

.12 The practitioner may be engaged to gather information to enable the responsible party to evaluate the subject matter in connection with providing a written assertion. Regardless of the procedures performed by the practitioner, the responsible party must accept responsibility for its assertion and the subject matter and must not base its assertion solely on the practitioner's procedures.[5]

.13 Because the practitioner's role in an attest engagement is that of an *attester*, the practitioner should not take on the role of the responsible party in an attest engagement. Therefore, the need to clearly identify a responsible party is a prerequisite for an attest engagement. A practitioner may accept an engagement to perform an examination, a review or an agreed-upon procedures engagement on subject matter or an assertion related thereto provided that one of the following conditions is met.

a. The party wishing to engage the practitioner is responsible for the subject matter, or has a reasonable basis for providing a written assertion about the subject matter if the nature of the subject matter is such that a responsible party does not otherwise exist.

b. The party wishing to engage the practitioner is not responsible for the subject matter but is able to provide the practitioner, or have a third party who is responsible for the subject matter provide the

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[4] When the practitioner is unable to perform the inquiry and analytical or other procedures that he or she considers necessary to achieve the limited assurance contemplated by a review, or when the client is the responsible party and does not provide the practitioner with a written assertion, the review will be incomplete. A review that is incomplete is not an adequate basis for issuing a review report and, accordingly, the practitioner should withdraw from the engagement.

[5] See paragraph .112 regarding the practitioner's assistance in developing subject matter or criteria.

practitioner, with evidence of the third party's responsibility for the subject matter.

.14 The practitioner should obtain written acknowledgment or other evidence of the responsible party's responsibility for the subject matter, or the written assertion, as it relates to the objective of the engagement. The responsible party can acknowledge that responsibility in a number of ways, for example, in an engagement letter, a representation letter, or the presentation of the subject matter, including the notes thereto, or the written assertion. If the practitioner is not able to directly obtain written acknowledgment, the practitioner should obtain other evidence of the responsible party's responsibility for the subject matter (for example, by reference to legislation, a regulation, or a contract).

Applicability to Agreed-Upon Procedures Engagements

.15 An agreed-upon procedures attest engagement is one in which a practitioner is engaged to issue a report of findings based on specific procedures performed on subject matter. The general, fieldwork, and reporting standards for attest engagements set forth in this section are applicable to agreed-upon procedures engagements. Because the application of these standards to agreed-upon procedures engagements is discussed in section 201, *Agreed-Upon Procedures Engagements*, such engagements are not discussed further in this section.

The Relationship of Attestation Standards to Quality Control Standards

.16 The practitioner is responsible for compliance with the American Institute of Certified Public Accountants' (AICPA's) Statements on Standards for Attestation Engagements (SSAEs) in an attest engagement. Rule 202, *Compliance With Standards*, of the Code of Professional Conduct [ET section 202.01], requires members to comply with such standards when conducting professional services.

.17 A firm of practitioners has a responsibility to adopt a system of quality control in the conduct of a firm's attest practice.[6] Thus, a firm should establish quality control policies and procedures to provide it with reasonable assurance that its personnel comply with the attestation standards in its attest engagements. The nature and extent of a firm's quality control policies and procedures depend on factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations. [As amended, effective September 2002, by Statement on Standards for Attestation Engagements No. 12.]

.18 Attestation standards relate to the conduct of individual attest engagements; quality control standards relate to the conduct of a firm's attest practice as a whole. Thus, attestation standards and quality control standards are related and the quality control policies and procedures that a firm adopts may

[6] The elements of quality control are identified in Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* [QC section 20]. A system of quality control is broadly defined as a process to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality. [As amended, effective September 2002, by Statement on Standards for Attestation Engagements No. 12.]

affect both the conduct of individual attest engagements and the conduct of a firm's attest practice as a whole. However, deficiencies in or instances of noncompliance with a firm's quality control policies and procedures do not, in and of themselves, indicate that a particular engagement was not performed in accordance with attestation standards. [As amended, effective September 2002, by Statement on Standards for Attestation Engagements No. 12.]

General Standards

Training and Proficiency

.19 The first general standard is—*The engagement shall be performed by a practitioner having adequate technical training and proficiency in the attest function.*

.20 Performing attest services is different from preparing and presenting subject matter or an assertion. The latter involves collecting, classifying, summarizing, and communicating information; this usually entails reducing a mass of detailed data to a manageable and understandable form. On the other hand, performing attest services involves gathering evidence to support the subject matter or the assertion and objectively assessing the measurements and communications of the responsible party. Thus, attest services are analytical, critical, investigative, and are concerned with the basis and support for the subject matter or the assertion.

Adequate Knowledge of Subject Matter

.21 The second general standard is—*The engagement shall be performed by a practitioner having adequate knowledge of the subject matter.*

.22 A practitioner may obtain adequate knowledge of the subject matter through formal or continuing education, including self-study, or through practical experience. However, this standard does not necessarily require a practitioner to personally acquire all of the necessary knowledge in the subject matter to be qualified to express a conclusion. This knowledge requirement may be met, in part, through the use of one or more specialists on a particular attest engagement if the practitioner has sufficient knowledge of the subject matter (*a*) to communicate to the specialist the objectives of the work and (*b*) to evaluate the specialist's work to determine if the objectives were achieved.

Suitability and Availability of Criteria

.23 The third general standard is—*The practitioner shall perform the engagement only if he or she has reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users.*

Suitability of Criteria

.24 Criteria are the standards or benchmarks used to measure and present the subject matter and against which the practitioner evaluates the subject matter.[*] Suitable criteria must have each of the following attributes:

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[*] An example of suitable criteria are the Trust Services criteria (includes WebTrust and SysTrust) developed by the AICPA's Assurance Services Executive Committee. These criteria may be used when the subject matter of the engagement is the security, availability, processing integrity, online privacy, or confidentiality of a system. The Trust Services criteria are presented in sections 100 and 200 of the AICPA's *Technical Practice Aids*. [Footnote added by the Assurance Services Executive Committee, January 2003.]

- *Objectivity*—Criteria should be free from bias.
- *Measurability*—Criteria should permit reasonably consistent measurements, qualitative or quantitative, of subject matter.
- *Completeness*—Criteria should be sufficiently complete so that those relevant factors that would alter a conclusion about subject matter are not omitted.
- *Relevance*—Criteria should be relevant to the subject matter.

.25 Criteria that are established or developed by groups composed of experts that follow due process procedures, including exposure of the proposed criteria for public comment, ordinarily should be considered suitable. Criteria promulgated by a body designated by the AICPA Governing Council under the AICPA Code of Professional Conduct are, by definition, considered to be suitable.

.26 Criteria may be established or developed by the client, the responsible party, industry associations, or other groups that do not follow due process procedures or do not as clearly represent the public interest. To determine whether these criteria are suitable, the practitioner should evaluate them based on the attributes described in paragraph .24.

.27 Regardless of who establishes or develops the criteria, the responsible party or the client is responsible for selecting the criteria and the client is responsible for determining that such criteria are appropriate for its purposes.

.28 The use of suitable criteria does not presume that all persons or groups would be expected to select the same criteria in evaluating the same subject matter. There may be more than one set of suitable criteria for a given subject matter. For example, in an engagement to express assurance about customer satisfaction, a responsible party may select as a criterion for customer satisfaction that all customer complaints are resolved to the satisfaction of the customer. In other cases, another responsible party may select a different criterion, such as the number of repeat purchases in the three months following the initial purchase.

.29 In evaluating the measurability attribute as described in paragraph .24, the practitioner should consider whether the criteria are sufficiently precise to permit people having competence in and using the same measurement criterion to be able to ordinarily obtain materially similar measurements. Consequently, practitioners should not perform an engagement when the criteria are so subjective or vague that reasonably consistent measurements, qualitative or quantitative, of subject matter cannot ordinarily be obtained. However, practitioners will not always reach the same conclusion because such evaluations often require the exercise of considerable professional judgment.

.30 For the purpose of assessing whether the use of particular criteria can be expected to yield reasonably consistent measurement and evaluation, consideration should be given to the nature of the subject matter. For example, *soft information*, such as forecasts or projections, would be expected to have a wider range of reasonable estimates than *hard* data, such as the calculated investment performance of a defined portfolio of managed investment products.

.31 Some criteria may be appropriate for only a limited number of parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria. For instance, criteria set forth in a lease agreement for override payments may be appropriate only for reporting

to the parties to the agreement because of the likelihood that such criteria would be misunderstood or misinterpreted by parties other than those who have specifically agreed to the criteria. Such criteria can be agreed upon directly by the parties or through a designated representative. If a practitioner determines that such criteria are appropriate only for a limited number of parties, the use of the report should be restricted to those specified parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria.

.32 The third general standard in paragraph .23 applies equally regardless of the level of the attest service to be provided. Consequently, it is inappropriate to perform a review engagement if the practitioner concludes that an examination cannot be performed because competent persons using the same criteria would not be able to obtain materially similar evaluations.

Availability of Criteria

.33 The criteria should be available to users in one or more of the following ways:

a. Available publicly

b. Available to all users through inclusion in a clear manner in the presentation of the subject matter or in the assertion

c. Available to all users through inclusion in a clear manner in the practitioner's report

d. Well understood by most users, although not formally available (for example, "The distance between points A and B is twenty feet;" the criterion of distance measured in feet is considered to be well understood)

e. Available only to specified parties; for example, terms of a contract or criteria issued by an industry association that are available only to those in the industry

.34 If criteria are only available to specified parties, the practitioner's report should be restricted to those parties who have access to the criteria as described in paragraphs .78 and .80.

Independence

.35 The fourth general standard is—*In all matters relating to the engagement, an independence in mental attitude shall be maintained by the practitioner*.[7]

.36 The practitioner should maintain the intellectual honesty and impartiality necessary to reach an unbiased conclusion about the subject matter or the assertion. This is a cornerstone of the attest function.

.37 In the final analysis, independence in mental attitude means objective consideration of facts, unbiased judgments, and honest neutrality on the part

[7] The practitioner performing an attest engagement should be *independent* pursuant to Rule 101, *Independence*, of the Code of Professional Conduct [ET section 101.01]. Interpretation No. 11, "Independence and the Performance of Professional Services Under the Statements on Standards for Attestation Engagements and Statement on Auditing Standards No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*," [ET section 101.13], to rule 101 [ET section 101.01] provides guidance about its application to certain attest engagements.

of the practitioner in forming and expressing conclusions. It implies not the attitude of an advocate or an adversary but an impartiality that recognizes an obligation for fairness. Independence in mental attitude presumes an undeviating concern for an unbiased conclusion about the subject matter or an assertion no matter what the subject matter or the assertion may be.

.38 The profession has established, through the AICPA's Code of Professional Conduct, precepts to guard against the *presumption* of loss of independence. Presumption is stressed because the possession of intrinsic independence is a matter of personal quality rather than of rules that formulate certain objective tests. Insofar as these precepts have been incorporated in the profession's code, they have the force of professional law for the independent practitioner.

Due Professional Care

.39 The fifth general standard is—*Due professional care shall be exercised in the planning and performance of the engagement.*

.40 Due professional care imposes a responsibility on each practitioner involved with the engagement to observe each of the attestation standards. Exercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including the preparation of the report.

.41 *Cooley on Torts*, a legal treatise, describes the obligation for due care as follows:

> Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all these employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretentions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon mere errors of judgment.[8]

Standards of Fieldwork

Planning and Supervision

.42 The first standard of fieldwork is—*The work shall be adequately planned and assistants, if any, shall be properly supervised.*

.43 Proper planning and supervision contribute to the effectiveness of attest procedures. Proper planning directly influences the selection of appropriate procedures and the timeliness of their application, and proper supervision helps ensure that planned procedures are appropriately applied.

.44 Planning an attest engagement involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a

[8] D. Haggard, *Cooley on Torts,* 472 (4th ed., 1932).

strategy, practitioners need to have sufficient knowledge to enable them to understand adequately the events, transactions, and practices that, in their judgment, have a significant effect on the subject matter or the assertion.

.45 Factors to be considered by the practitioner in planning an attest engagement include the following:

a. The criteria to be used

b. Preliminary judgments about attestation risk[9] and materiality for attest purposes

c. The nature of the subject matter or the items within the assertion that are likely to require revision or adjustment

d. Conditions that may require extension or modification of attest procedures

e. The nature of the report expected to be issued

.46 The practitioner should establish an understanding with the client regarding the services to be performed for each engagement.[10] Such an understanding reduces the risk that either the practitioner or the client may misinterpret the needs or expectations of the other party. For example, it reduces the risk that the client may inappropriately rely on the practitioner to protect the entity against certain risks or to perform certain functions that are the client's responsibility. The understanding should include the objectives of the engagement, management's responsibilities, the practitioner's responsibilities, and limitations of the engagement. The practitioner should document the understanding in the working papers, preferably through a written communication with the client. If the practitioner believes an understanding with the client has not been established, he or she should decline to accept or perform the engagement.

.47 The nature, extent, and timing of planning will vary with the nature and complexity of the subject matter or the assertion and the practitioner's prior experience with management. As part of the planning process, the practitioner should consider the nature, extent, and timing of the work to be performed to accomplish the objectives of the attest engagement. Nevertheless, as the attest engagement progresses, changed conditions may make it necessary to modify planned procedures.

.48 Supervision involves directing the efforts of assistants who participate in accomplishing the objectives of the attest engagement and determining whether those objectives were accomplished. Elements of supervision include instructing assistants, staying informed of significant problems encountered, reviewing the work performed, and dealing with differences of opinion among personnel. The extent of supervision appropriate in a given instance depends on many factors, including the nature and complexity of the subject matter and the qualifications of the persons performing the work.

.49 Assistants should be informed of their responsibilities, including the objectives of the procedures that they are to perform and matters that may affect the nature, extent, and timing of such procedures. The practitioner with

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[9] *Attestation risk* is the risk that the practitioner may unknowingly fail to appropriately modify his or her attest report on the subject matter or an assertion that is materially misstated. It consists of (*a*) the risk (consisting of *inherent risk* and *control risk*) that the subject matter or assertion contains deviations or misstatements that could be material and (*b*) the risk that the practitioner will not detect such deviations or misstatements (*detection risk*).

[10] See SQCS No. 2, paragraph 16 [QC section 20.16].

final responsibility for the engagement should direct assistants to bring to his or her attention significant questions raised during the attest engagement so that their significance may be assessed.

.50 The work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusion to be presented in the practitioner's report.

Obtaining Sufficient Evidence

.51 The second standard of fieldwork is—*Sufficient evidence shall be obtained to provide a reasonable basis for the conclusion that is expressed in the report.*

.52 Selecting and applying procedures that will accumulate evidence that is sufficient in the circumstances to provide a reasonable basis for the level of assurance to be expressed in the attest report requires the careful exercise of professional judgment. A broad array of available procedures may be applied in an attest engagement. In establishing a proper combination of procedures to appropriately restrict attestation risk, the practitioner should consider the following presumptions, bearing in mind that they are not mutually exclusive and may be subject to important exceptions.

a. Evidence obtained from independent sources outside an entity provides greater assurance about the subject matter or the assertion than evidence secured solely from within the entity.

b. Information obtained from the independent attester's direct personal knowledge (such as through physical examination, observation, computation, operating tests, or inspection) is more persuasive than information obtained indirectly.

c. The more effective the controls over the subject matter, the more assurance they provide about the subject matter or the assertion.

.53 Thus, in the hierarchy of available attest procedures, those that involve search and verification (for example, inspection, confirmation, or observation), particularly when using independent sources outside the entity, are generally more effective in restricting attestation risk than those involving internal inquiries and comparisons of internal information (for example, analytical procedures and discussions with individuals responsible for the subject matter or the assertion). On the other hand, the latter are generally less costly to apply.

.54 In an attest engagement designed to provide a high level of assurance (referred to as an *examination*), the practitioner's objective is to accumulate sufficient evidence to restrict attestation risk to a level that is, in the practitioner's professional judgment, appropriately low for the high level of assurance that may be imparted by his or her report. In such an engagement, a practitioner should select from all available procedures—that is, procedures that assess inherent and control risk and restrict detection risk—any combination that can restrict attestation risk to such an appropriately low level.

.55 In an attest engagement designed to provide a moderate level of assurance (referred to as a *review*), the objective is to accumulate sufficient evidence to restrict attestation risk to a moderate level. To accomplish this, the types of procedures performed generally are limited to inquiries and analytical procedures (rather than also including search and verification procedures).

.56 Nevertheless, there will be circumstances in which inquiry and analytical procedures (*a*) cannot be performed, (*b*) are deemed less efficient than other procedures, or (*c*) yield evidence indicating that the subject matter or the

assertion may be incomplete or inaccurate. In the first circumstance, the practitioner should perform other procedures that he or she believes can provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would have provided. In the second circumstance, the practitioner may perform other procedures that he or she believes would be more efficient to provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would provide. In the third circumstance, the practitioner should perform additional procedures.

.57 The extent to which attestation procedures will be performed should be based on the level of assurance to be provided and the practitioner's consideration of (*a*) the nature and materiality of the information to be tested to the subject matter or the assertion taken as a whole, (*b*) the likelihood of misstatements, (*c*) knowledge obtained during current and previous engagements, (*d*) the responsible party's competence in the subject matter, (*e*) the extent to which the information is affected by the asserter's judgment, and (*f*) inadequacies in the responsible party's underlying data.

.58 As part of the attestation procedures, the practitioner considers the written assertion ordinarily provided by the responsible party. If a written assertion cannot be obtained from the responsible party, the practitioner should consider the effects on his or her ability to obtain sufficient evidence to form a conclusion about the subject matter. When the practitioner's client is the responsible party, a failure to obtain a written assertion should result in the practitioner concluding that a scope limitation exists.[11] When the practitioner's client is not the responsible party and a written assertion is not provided, the practitioner may be able to conclude that he or she has sufficient evidence to form a conclusion about the subject matter.

Representation Letter

.59 During an attest engagement, the responsible party makes many representations to the practitioner, both oral and written, in response to specific inquiries or through the presentation of subject matter or an assertion. Such representations from the responsible party are part of the evidential matter the practitioner obtains.

.60 Written representations from the responsible party ordinarily confirm representations explicitly or implicitly given to the practitioner, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding concerning the matters that are the subject of the representations. Accordingly, in an examination or a review engagement, a practitioner should consider obtaining a representation letter from the responsible party. Examples of matters that might appear in such a representation letter include the following:[12]

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[11] When the client is the responsible party, it is presumed that the client will be capable of providing the practitioner with a written assertion regarding the subject matter. Failure to provide the written assertion in this circumstance is a client-imposed limitation on the practitioner's evidence-gathering efforts. In an examination, the practitioner should modify the report for the scope limitation. In a review engagement, such a scope limitation results in an incomplete review and the practitioner should withdraw from the engagement.

[12] Specific written representations will depend on the circumstances of the engagement (for example, whether the client is the responsible party) and the nature of the subject matter and the criteria. For example, when the client is not the responsible party but has selected the criteria, the practitioner might obtain the representation regarding responsibility for selection of the criteria from the client rather than the responsible party (see paragraph .61).

a. A statement acknowledging responsibility for the subject matter and, when applicable, the assertion

b. A statement acknowledging responsibility for selecting the criteria, where applicable

c. A statement acknowledging responsibility for determining that such criteria are appropriate for its purposes, where the responsible party is the client

d. The assertion about the subject matter based on the criteria selected

e. A statement that all known matters contradicting the assertion and any communication from regulatory agencies affecting the subject matter or the assertion have been disclosed to the practitioner

f. Availability of all records relevant to the subject matter

g. A statement that any known events subsequent to the period (or point in time) of the subject matter being reported on that would have a material effect on the subject matter (or, if applicable, the assertion) have been disclosed to the practitioner

h. Other matters as the practitioner deems appropriate

.61 When the client is not the responsible party, the practitioner should consider obtaining a letter of written representations from the client as part of the attest engagement. Examples of matters that might appear in such a representation letter include the following:

a. A statement that any known events subsequent to the period (or point in time) of the subject matter being reported on that would have a material effect on the subject matter (or, if applicable, the assertion) have been disclosed to the practitioner

b. A statement acknowledging the client's responsibility for selecting the criteria, where applicable

c. A statement acknowledging the client's responsibility for determining that such criteria are appropriate for its purposes

d. Other matters as the practitioner deems appropriate

.62 If the responsible party or the client refuses to furnish all written representations that the practitioner deems necessary, the practitioner should consider the effects of such a refusal on his or her ability to issue a conclusion about the subject matter. If the practitioner believes that the representation letter is necessary to obtain sufficient evidence to issue a report, the responsible party's or the client's refusal to furnish such evidence in the form of written representations constitutes a limitation on the scope of an examination sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause the practitioner to disclaim an opinion or withdraw from an examination engagement. However, based on the nature of the representations not obtained or the circumstances of the refusal, the practitioner may conclude, in an examination engagement, that a qualified opinion is appropriate. Further, the practitioner should consider the effects of the refusal on his or her ability to rely on other representations. When a scope limitation exists in a review engagement, the practitioner should withdraw from the engagement. (See paragraph .75.)

Standards of Reporting

.63 The first standard of reporting is—*The report shall identify the subject matter or the assertion being reported on and state the character of the engagement.*

.64 The practitioner who accepts an attest engagement should issue a report on the subject matter or the assertion or withdraw from the attest engagement. If the practitioner is reporting on the assertion, the assertion should be bound with or accompany the practitioner's report or the assertion should be clearly stated in the practitioner's report.[13]

.65 The statement of the character of an attest engagement includes the following two elements: (*a*) a description of the nature and scope of the work performed and (*b*) a reference to the professional standards governing the engagement. The terms *examination* and *review* should be used to describe engagements to provide, respectively, a high level and a moderate level of assurance. The reference to professional standards should be accomplished by referring to "attestation standards established by the American Institute of Certified Public Accountants."

.66 The second standard of reporting is—*The report shall state the practitioner's conclusion about the subject matter or the assertion in relation to the criteria against which the subject matter was evaluated.* However, if conditions exist that, individually or in combination, result in one or more material misstatements or deviations from the criteria, the practitioner should modify the report and, to most effectively communicate with the reader of the report, should ordinarily express his or her conclusion directly on the subject matter,[14] not on the assertion.

.67 The practitioner should consider the concept of materiality in applying this standard. In expressing a conclusion, the practitioner should consider an omission or a misstatement to be material if the omission or misstatement—individually or when aggregated with others—is such that a reasonable person would be influenced by the omission or misstatement. The practitioner should consider both qualitative and quantitative aspects of omissions and misstatements.

.68 The term *general use* applies to attest reports that are not restricted to specified parties. General-use attest reports should be limited to two levels of assurance: one based on a restriction of attestation risk to an appropriately low level (an *examination*) and the other based on a restriction of attestation risk to a moderate level (a *review*). In an engagement to achieve a high level of assurance (an *examination*), the practitioner's conclusion should be expressed in the form of an opinion. When attestation risk has been restricted only to a moderate level (a *review*), the conclusion should be expressed in the form of negative assurance.

.69 A practitioner may report on subject matter or an assertion at multiple dates or covering multiple periods during which criteria have changed (for example, a report on comparative information). In those circumstances, the practitioner should determine whether the criteria are clearly stated or described for each of the dates or periods, and whether the changes have been adequately disclosed.

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[13] The use of a "hot link" within the practitioner's report to management's assertion, such as might be used in a WebTrustSM report, would meet this requirement.

[14] Specific standards may require that the practitioner express his or her conclusion directly on the subject matter. For example, if management states in its assertion that a material weakness exists in the entity's internal control over financial reporting, the practitioner should state his or her opinion directly on the effectiveness of internal control, not on management's assertion related thereto.

.70 If the criteria used for the subject matter for the current date or period differ from those criteria used for the subject matter for a preceding date or period and the subject matter for the prior date or period is not presented, the practitioner should consider whether the changes in criteria are likely to be significant to users of the report. If so, the practitioner should determine whether the criteria are clearly stated or described and the fact that the criteria have changed is disclosed. (See paragraphs .76 and .77.)

.71 The third standard of reporting is—*The report shall state all of the practitioner's significant reservations about the engagement, the subject matter, and, if applicable, the assertion related thereto.*

.72 *Reservations about the engagement* refers to any unresolved problem that the practitioner had in complying with these attestation standards, interpretive standards, or the specific procedures agreed to by the specified parties. The practitioner should not express an unqualified conclusion unless the engagement has been conducted in accordance with the attestation standards. Such standards will not have been complied with if the practitioner has been unable to apply all the procedures that he or she considers necessary in the circumstances.

.73 Restrictions on the scope of an engagement, whether imposed by the client or by such other circumstances as the timing of the work or the inability to obtain sufficient evidence, may require the practitioner to qualify the assurance provided, to disclaim any assurance, or to withdraw from the engagement. For example, if the practitioner's client is the responsible party, a failure to obtain a written assertion should result in the practitioner concluding that a scope limitation exists. (See paragraph .58.)

.74 The practitioner's decision to provide a qualified opinion, to disclaim an opinion, or to withdraw because of a scope limitation in an examination engagement depends on an assessment of the effect of the omitted procedure(s) on his or her ability to express assurance. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question, and by their significance to the subject matter or the assertion. If the potential effects are pervasive to the subject matter or the assertion, a disclaimer or withdrawal is more likely to be appropriate. When restrictions that significantly limit the scope of the engagement are imposed by the client or the responsible party, the practitioner generally should disclaim an opinion or withdraw from the engagement. The reasons for a qualification or disclaimer should be described in the practitioner's report.

.75 In a review engagement, when the practitioner is unable to perform the inquiry and analytical or other procedures he or she considers necessary to achieve the limited assurance contemplated by a review, or when the client is the responsible party and does not provide the practitioner with a written assertion, the review will be incomplete. A review that is incomplete is not an adequate basis for issuing a review report and, accordingly, the practitioner should withdraw from the engagement.

.76 *Reservations about the subject matter or the assertion* refers to any unresolved reservation about the assertion or about the conformity of the subject matter with the criteria, including the adequacy of the disclosure of material matters. They can result in either a qualified or an adverse opinion, depending on the materiality of the departure from the criteria against which the subject matter or the assertion was evaluated, or a modified conclusion in a review engagement.

.77 Reservations about the subject matter or the assertion may relate to the measurement, form, arrangement, content, or underlying judgments and assumptions applicable to the subject matter or the assertion and its appended notes, including, for example, the terminology used, the amount of detail given, the classification of items, and the bases of amounts set forth. The practitioner considers whether a particular reservation should affect the report given the circumstances and facts of which he or she is aware at the time.

.78 The fourth standard of reporting is—*The report shall state that the use of the report is restricted to specified parties under the following circumstances:*

- *When the criteria used to evaluate the subject matter are determined by the practitioner to be appropriate only for a limited number of parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria*
- *When the criteria used to evaluate the subject matter are available only to specified parties*
- *When reporting on subject matter and a written assertion has not been provided by the responsible party*
- *When the report is on an attest engagement to apply agreed-upon procedures to the subject matter*

.79 The need for restriction on the use of a report may result from a number of circumstances, including the purpose of the report, the criteria used in preparation of the subject matter, the extent to which the procedures performed are known or understood, and the potential for the report to be misunderstood when taken out of the context in which it was intended to be used. A practitioner should consider informing his or her client that restricted-use reports are not intended for distribution to nonspecified parties, regardless of whether they are included in a document containing a separate general-use report.[15,16] However, a practitioner is not responsible for controlling a client's distribution of restricted-use reports. Accordingly, a restricted-use report should alert readers to the restriction on the use of the report by indicating that the report is not intended to be and should not be used by anyone other than the specified parties.

.80 An attest report that is restricted as to use should contain a separate paragraph at the end of the report that includes the following elements:

a. A statement indicating that the report is intended solely for the information and use of the specified parties

b. An identification of the specified parties to whom use is restricted

c. A statement that the report is not intended to be and should not be used by anyone other than the specified parties

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[15] In some cases, restricted-use reports filed with regulatory agencies are required by law or regulation to be made available to the public as a matter of public record. Also, a regulatory agency as part of its oversight responsibility for an entity may require access to restricted-use reports in which they are not named as a specified party.

[16] This section does not preclude the practitioner, in connection with establishing the terms of the engagement, from reaching an understanding with the client that the intended use of the report will be restricted, and from obtaining the client's agreement that the client and the specified parties will not distribute the report to parties other than those identified in the report.

An example of such a paragraph is the following.

> This report is intended solely for the information and use of [*the specified parties*] and is not intended to be and should not be used by anyone other than these specified parties.

.81 Other attestation standards may specify situations that require restricted reports such as the following:

a. A review report on management's discussion and analysis

b. A report on prospective financial information when the report is intended for use by the responsible party alone, or by the responsible party and third parties with whom the responsible party is negotiating directly, as described in section 301, *Financial Forecasts and Projections*, paragraph .10.

Furthermore, nothing in this section precludes a practitioner from restricting the use of any report.

.82 If a practitioner issues a single combined report covering both (*a*) subject matter or presentations that require a restriction on use to specified parties and (*b*) subject matter or presentations that ordinarily do not require such a restriction, the use of such a single combined report should be restricted to the specified parties.

.83 In some instances, a separate restricted-use report may be included in a document that also contains a general-use report. The inclusion of a separate restricted-use report in a document that contains a general-use report does not affect the intended use of either report. The restricted-use report remains restricted as to use, and the general-use report continues to be for general use.

Examination Reports

.84 When expressing an opinion, the practitioner should clearly state whether, in his or her opinion, (*a*) the subject matter is based on (or in conformity with) the criteria in all material respects or (*b*) the assertion is presented (or fairly stated), in all material respects, based on the criteria. Reports expressing an opinion may be qualified or modified for some aspect of the subject matter, the assertion or the engagement (see the third reporting standard). However, as stated in paragraph .66, if conditions exist that, individually or in combination, result in one or more material misstatements or deviations from the criteria, the practitioner should modify the report and, to most effectively communicate with the reader of the report, should ordinarily express his or her conclusion directly on the subject matter, not on the assertion. In addition, such reports may emphasize certain matters relating to the attest engagement, the subject matter, or the assertion. The form of the practitioner's report will depend on whether the practitioner opines on the subject matter or the assertion.

.85 The practitioner's examination report on subject matter should include the following:

a. A title that includes the word *independent*

b. An identification of the subject matter and the responsible party

c. A statement that the subject matter is the responsibility of the responsible party

d. A statement that the practitioner's responsibility is to express an opinion on the subject matter based on his or her examination

e. A statement that the examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants, and, accordingly, included procedures that the practitioner considered necessary in the circumstances

f. A statement that the practitioner believes the examination provides a reasonable basis for his or her opinion

g. The practitioner's opinion on whether the subject matter is based on (or in conformity with) the criteria in all material respects

h. A statement restricting the use of the report to specified parties under the following circumstances (see paragraphs .78 to .83):

(1) When the criteria used to evaluate the subject matter are determined by the practitioner to be appropriate only for a limited number of parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria

(2) When the criteria used to evaluate the subject matter are available only to the specified parties

(3) When a written assertion has not been provided by the responsible party (The practitioner should also include a statement to that effect in the introductory paragraph of the report.)

i. The manual or printed signature of the practitioner's firm

j. The date of the examination report

Appendix A [paragraph .114], "Examination Reports," includes a standard examination report on subject matter. (See Example 1.)

.86 The practitioner's examination report on an assertion should include the following:

a. A title that includes the word *independent*

b. An identification of the assertion and the responsible party (When the assertion does not accompany the practitioner's report, the first paragraph of the report should also contain a statement of the assertion.)

c. A statement that the assertion is the responsibility of the responsible party

d. A statement that the practitioner's responsibility is to express an opinion on the assertion based on his or her examination

e. A statement that the examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants, and, accordingly, included procedures that the practitioner considered necessary in the circumstances

f. A statement that the practitioner believes the examination provides a reasonable basis for his or her opinion

g. The practitioner's opinion on whether the assertion is presented (or fairly stated), in all material respects, based on the criteria (However, see paragraph .66.)

h. A statement restricting the use of the report to specified parties under the following circumstances (see paragraphs .78 to .83):

(1) When the criteria used to evaluate the subject matter are determined by the practitioner to be appropriate only for a limited number of parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria

(2) When the criteria used to evaluate the subject matter are available only to the specified parties

i. The manual or printed signature of the practitioner's firm

j. The date of the examination report

Appendix A [paragraph .114] includes a standard examination report on an assertion. (See Example 2.)

.87 Nothing precludes the practitioner from examining an assertion but opining directly on the subject matter. (See Appendix A [paragraph .114], Example 3.)

Review Reports

.88 In a review report, the practitioner's conclusion should state whether any information came to the practitioner's attention on the basis of the work performed that indicates that (*a*) the subject matter is not based on (or in conformity with) the criteria or (*b*) the assertion is not presented (or fairly stated) in all material respects based on the criteria. (As discussed more fully in the commentary to the third reporting standard, if the subject matter or the assertion is not modified to correct for any such information that comes to the practitioner's attention, such information should be described in the practitioner's report.)

.89 The practitioner's review report on subject matter should include the following:

a. A title that includes the word *independent*

b. An identification of the subject matter and the responsible party

c. A statement that the subject matter is the responsibility of the responsible party

d. A statement that the review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants

e. A statement that a review is substantially less in scope than an examination, the objective of which is an expression of opinion on the subject matter, and accordingly, no such opinion is expressed

f. A statement about whether the practitioner is aware of any material modifications that should be made to the subject matter in order for it to be based on (or in conformity with), in all material respects, the criteria, other than those modifications, if any, indicated in his or her report

g. A statement restricting the use of the report to specified parties under the following circumstances (see paragraphs .78 to .83):

(1) When the criteria used to evaluate the subject matter are determined by the practitioner to be appropriate only for a limited number of parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria

(2) When the criteria used to evaluate the subject matter are available only to the specified parties

(3) When a written assertion has not been provided by the responsible party and the responsible party is not the client (The practitioner should also include a statement to that effect in the introductory paragraph of the report.)

h. The manual or printed signature of the practitioner's firm

i. The date of the review report

Appendix B [paragraph .115] "Review Reports," includes a standard review report on subject matter. (See Example 1.) Appendix B [paragraph .115] also includes a review report on subject matter that is the responsibility of a party other than client; the report is restricted as to use because a written assertion has not been provided by the responsible party. (See Example 2.)

.90 The practitioner's review report on an assertion should include the following:

a. A title that includes the word *independent*

b. An identification of the assertion and the responsible party (When the assertion does not accompany the practitioner's report, the first paragraph of the report should also contain a statement of the assertion.)

c. A statement that the assertion is the responsibility of the responsible party

d. A statement that the review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants

e. A statement that a review is substantially less in scope than an examination, the objective of which is an expression of opinion on the assertion, and accordingly, no such opinion is expressed

f. A statement about whether the practitioner is aware of any material modifications that should be made to the assertion in order for it to be presented (or fairly stated), in all material respects, based on (or in conformity with) the criteria, other than those modifications, if any, indicated in his or her report (However, see paragraph .66.)

g. A statement restricting the use of the report to specified parties under the following circumstances (see paragraphs .78 to .83):

(1) When the criteria used to evaluate the subject matter are determined by the practitioner to be appropriate only for a limited number of parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria

(2) When the criteria used to evaluate the subject matter are available only to the specified parties

h. The manual or printed signature of the practitioner's firm

i. The date of the review report

Appendix B [paragraph .115] includes a review report on an assertion that is restricted as to use because the criteria are available only to the specified parties. (See Example 3.)

Other Information in a Client-Prepared Document Containing the Practitioner's Attest Report[17]

.91 A client may publish various documents that contain information (hereinafter referred to as *other information*) in addition to the practitioner's attest report on subject matter (or on an assertion related thereto). Paragraphs .92 to .94 provide guidance to the practitioner when the other information is contained in (*a*) annual reports to holders of securities or beneficial interests, annual reports of organizations for charitable or philanthropic purposes distributed to the public, and annual reports filed with regulatory authorities under the Securities Exchange Act of 1934 or (*b*) other documents to which the practitioner, at the client's request, devotes attention. These paragraphs are not applicable when an attest report appears in a registration statement filed under the Securities Act of 1933. (See AU section 634, *Letters for Underwriters and Certain Other Requesting Parties,* and AU section 711, *Filings Under Federal Securities Statutes*.) Also, these paragraphs are not applicable to other information on which the practitioner or another practitioner is engaged to issue an opinion.

.92 The practitioner's responsibility with respect to other information in such a document does not extend beyond the information identified in his or her report, and the practitioner has no obligation to perform any procedures to corroborate any other information contained in the document. However, the practitioner should read the other information not covered by the practitioner's report or by the report of the other practitioner and consider whether it, or the manner of its presentation, is materially inconsistent with the information appearing in the practitioner's report. If the practitioner believes that the other information is inconsistent with the information appearing in the practitioner's report, he or she should consider whether the practitioner's report requires revision. If the practitioner concludes that the report does not require revision, he or she should request the client to revise the other information. If the other information is not revised to eliminate the material inconsistency, the practitioner should consider other actions, such as revising his or her report to include an explanatory paragraph describing the material inconsistency, withholding the use of his or her report in the document, or withdrawing from the engagement.

.93 If, while reading the other information for the reasons set forth in paragraph .92, the practitioner becomes aware of information that he or she believes is a material misstatement of fact that is not a material inconsistency as described in paragraph .92, he or she should discuss the matter with the client. In connection with this discussion, the practitioner should consider that he or she may not have the expertise to assess the validity of the statement, that there may be no standards by which to assess its presentation, and that there may be valid differences of judgment or opinion. If the practitioner concludes he or she has a valid basis for concern, the practitioner should propose that the client consult with some other party whose advice may be useful, such as the entity's legal counsel.

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[17] Such guidance pertains only to other information in a client-prepared document. The practitioner has no responsibility to read information contained in documents of nonclients. Further, the practitioner is not required to read information contained in electronic sites, or to consider the consistency of other information in electronic sites with the original documents since electronic sites are a means of distributing information and are not "documents" as that term is used in this section. Practitioners may be asked by their clients to render attest services with respect to information in electronic sites, in which case, other attest standards may apply to those services.

.94 If, after discussing the matter, the practitioner concludes that a material misstatement of fact remains, the action taken will depend on his or her judgment in the circumstances. The practitioner should consider steps such as notifying the client's management and audit committee in writing of his or her views concerning the information and consulting his or her legal counsel about further action appropriate in the circumstances.[18]

Consideration of Subsequent Events in an Attest Engagement

.95 Events or transactions sometimes occur subsequent to the point in time or period of time of the subject matter being tested but prior to the date of the practitioner's report that have a material effect on the subject matter and therefore require adjustment or disclosure in the presentation of the subject matter or assertion. These occurrences are referred to as *subsequent events*. In performing an attest engagement, a practitioner should consider information about subsequent events that comes to his or her attention. Two types of subsequent events require consideration by the practitioner.

.96 The first type consists of events that provide additional information with respect to conditions that existed at the point in time or during the period of time of the subject matter being tested. This information should be used by the practitioner in considering whether the subject matter is presented in conformity with the criteria and may affect the presentation of the subject matter, the assertion, or the practitioner's report.

.97 The second type consists of those events that provide information with respect to conditions that arose subsequent to the point in time or period of time of the subject matter being tested that are of such a nature and significance that their disclosure is necessary to keep the subject matter from being misleading. This type of information will not normally affect the practitioner's report if the information is appropriately disclosed.

.98 While the practitioner has no responsibility to detect subsequent events, the practitioner should inquire of the responsible party (and his or her client if the client is not the responsible party) as to whether they are aware of any subsequent events, through the date of the practitioner's report, that would have a material effect on the subject matter or assertion.[19] If the practitioner has decided to obtain a representation letter, the letter ordinarily would include a representation concerning subsequent events. (See paragraphs .60 and .61.)

.99 The practitioner has no responsibility to keep informed of events subsequent to the date of his or her report; however, the practitioner may later

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[18] If the client does not have an audit committee, the practitioner should communicate with individuals whose authority and responsibility are equivalent to those of an audit committee, such as the board of directors, the board of trustees, an owner in a owner-managed entity, or those who engaged the practitioner.

[19] For certain subject matter, specific subsequent event standards have been developed to provide additional requirements for engagement performance and reporting. Additionally, a practitioner engaged to examine the design or effectiveness of internal control over items not covered by section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*, or section 601, *Compliance Attestation*, should consider the subsequent events guidance set forth in sections 501.65–.68 and 601.50–.52.

become aware of conditions that existed at that date that might have affected the practitioner's report had he or she been aware of them. In such circumstances, the practitioner may wish to consider the guidance in AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

Attest Documentation[20]

.100 The practitioner should prepare and maintain attest documentation, the form and content of which should be designed to meet the circumstances of the particular attest engagement.[21] Attest documentation is the principal record of attest procedures applied, information obtained, and conclusions or findings reached by the practitioner in the engagement. The quantity, type, and content of attest documentation are matters of the practitioner's professional judgment. [As amended, effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002, by Statement on Standards for Attestation Engagements No. 11.]

.101 Attest documentation serves mainly to:

a. Provide the principal support for the practitioner's report, including the representation regarding observance of the standards of fieldwork, which is implicit in the reference in the report to attestation standards.[22]

b. Aid the practitioner in the conduct and supervision of the attest engagement.

For examinations of prospective financial statements, attest documentation ordinarily should indicate that the process by which the entity develops its prospective financial statements was considered in determining the scope of the examination. [Paragraph added, effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002, by Statement on Standards for Attestation Engagements No. 11.]

.102 Examples of attest documentation are work programs, analyses, memoranda, letters of confirmation and representation, abstracts or copies of entity documents, and schedules or commentaries prepared or obtained by the practitioner. Attest documentation may be in paper form, electronic form, or other media. [Paragraph renumbered and amended, effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002, by Statement on Standards for Attestation Engagements No. 11.]

.103 Attest documentation should be sufficient to (*a*) enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of attest procedures performed,

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[20] *Attest documentation* also may be referred to as *working papers*. [Footnote added, effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002, by Statement on Standards for Attestation Engagements No. 11.]

[21] [Footnote renumbered and deleted by the issuance of Statement on Standards for Attestation Engagements No. 11, January 2002.]

[22] However, there is no intention to imply that the practitioner would be precluded from supporting his or her report by other means in addition to attest documentation. [Footnote added, effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002, by Statement on Standards for Attestation Engagements No. 11.]

and the information obtained[23] and (*b*) indicate the engagement team member(s) who performed and reviewed the work. [Paragraph added, effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002, by Statement on Standards for Attestation Engagements No. 11.]

.104 Attest documentation is the property of the practitioner, and some states recognize this right of ownership in their statutes. The practitioner should adopt reasonable procedures to retain attest documentation for a period of time sufficient to meet the needs of his or her practice and to satisfy any applicable legal or regulatory requirements for records retention.[24,[25]] [Paragraph renumbered and amended, effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002, by Statement on Standards for Attestation Engagements No. 11.]

.105 The practitioner has an ethical, and in some situations a legal, obligation to maintain the confidentiality of client information or information of the responsible party.[26] Because attest documentation often contains confidential information, the practitioner should adopt reasonable procedures to maintain the confidentiality of that information.[†] [Paragraph added, effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002, by Statement on Standards for Attestation Engagements No. 11.]

.106 The practitioner also should adopt reasonable procedures to prevent unauthorized access to attest documentation. [Paragraph added, effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002, by Statement on Standards for Attestation Engagements No. 11.]

.107 Certain attest documentation may sometimes serve as a useful reference source for the client, but it should not be regarded as a part of, or a substitute for, the client's records. [Paragraph renumbered and amended, effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002, by Statement on Standards for Attestation Engagements No. 11.]

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[23] A firm of practitioners has a responsibility to adopt a system of quality control policies and procedures to provide the firm with reasonable assurance that its personnel comply with applicable professional standards, including attestation standards, and the firm's standards of quality in conducting individual attest engagements. Review of attest documentation and discussions with engagement team members are among the procedures a firm performs when monitoring compliance with the quality control policies and procedures that it has established. (Also, see paragraphs .17 and .18.) [Footnote added, effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002, by Statement on Standards for Attestation Engagements No. 11.]

[24] The procedures should enable the practitioner to access electronic attest documentation throughout the retention period. [Footnote added, effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002, by Statement on Standards for Attestation Engagements No. 11.]

[25] [Footnote renumbered and deleted by the issuance of Statement on Standards for Attestation Engagements No. 11, January 2002.]

[26] Also, see Rule 301, *Confidential Client Information*, of the AICPA's Code of Professional Conduct. [Footnote added, effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002, by Statement on Standards for Attestation Engagements No. 11.]

[†] ***Note:*** See the Attest Interpretation, "Providing Access to or Copies of Attest Documentation to a Regulator" (section 9101.43–.46).

[.108] [Paragraph renumbered and deleted by the issuance of Statement on Standards for Attestation Engagements No. 11, January 2002.]

Attest Services Related to Consulting Service Engagements

Attest Services as Part of a Consulting Service Engagement

.109 When a practitioner provides an attest service (as defined in this section) as part of a consulting service engagement, this SSAE applies only to the attest service. The SSCS applies to the balance of the consulting service engagement. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 11, January 2002.]

.110 When the practitioner determines that an attest service is to be provided as part of a consulting service engagement, the practitioner should inform the client of the relevant differences between the two types of services and obtain concurrence that the attest service is to be performed in accordance with the appropriate professional requirements. The practitioner should take such actions because the professional requirements for an attest service differ from those for a consulting service engagement. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 11, January 2002.]

.111 The practitioner should issue separate reports on the attest engagement and the consulting service engagement and, if presented in a common binder, the report on the attest engagement or service should be clearly identified and segregated from the report on the consulting service engagement. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 11, January 2002.]

Subject Matter, Assertions, Criteria, and Evidence

.112 An attest service may involve subject matter, an assertion, criteria, or evidential matter developed during a concurrent or prior consulting service engagement. Subject matter or an assertion developed with the practitioner's advice and assistance as the result of such consulting services engagement may be the subject of an attest engagement, provided the responsible party accepts and acknowledges responsibility for the subject matter or assertion. (See paragraph .12.) Criteria developed with the practitioner's assistance may be used to evaluate subject matter in an attest engagement, provided such criteria meet the requirements of this section. Relevant information obtained in the course of a concurrent or prior consulting service engagement may be used as evidential matter in an attest engagement, provided the information satisfies the requirements of this section. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 11, January 2002.]

Effective Date

.113 This section is effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001. Early application is permitted. [Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 11, January 2002.]

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Appendix A

Examination Reports

Example 1

This is a standard examination report on subject matter for general use. This report pertains to subject matter for which suitable criteria exist and are available to all users through inclusion in a clear manner in the presentation of the subject matter. (See paragraphs .78 to .83 for guidance on restricting the use of the report when criteria are available only to specified parties; see Example 4 for an illustration of such a report.) A written assertion has been obtained from the responsible party.

Independent Accountant's Report

We have examined the [*identify the subject matter—for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX*]. XYZ Company's management is responsible for the schedule of investment returns. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting [*identify the subject matter—for example, XYZ Company's schedule of investment returns*] and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the subject matter.*]

In our opinion, the schedule referred to above presents, in all material respects, [*identify the subject matter—for example, the investment returns of XYZ Company for the year ended December 31, 20XX*] based on [*identify criteria—for example, the ABC criteria set forth in Note 1*].

[*Signature*]

[*Date*]

Example 2

This report is a standard examination report on an assertion for general use. The report pertains to subject matter for which suitable criteria exist and are available to all users through inclusion in a clear manner in the presentation of the subject matter. (See paragraphs .78 to .83 for guidance on restricting the use of the report when criteria are available only to specified parties.) A written assertion has been obtained from the responsible party.

Independent Accountant's Report

We have examined management's assertion that [*identify the assertion—for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX is presented in accordance with ABC criteria set forth in Note 1*]. XYZ Company's management is responsible for the assertion. Our responsibility is to express an opinion on the assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting management's assertion and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the assertion.*]

In our opinion, management's assertion referred to above is fairly stated, in all material respects, based on [*identify established or stated criteria—for example, the ABC criteria set forth in Note 1*].

[*Signature*]

[*Date*]

Example 3

This is an examination report for general use; the introductory paragraph states the practitioner has examined management's assertion but the practitioner opines directly on the subject matter (see paragraph .87). The report pertains to subject matter for which suitable criteria exist and are available to all users through inclusion in a clear manner in the presentation of the subject matter. (See paragraphs .78 to .83 for guidance on restricting the use of the report when criteria are available only to specified parties.) A written assertion has been obtained from the responsible party.

Independent Accountant's Report

We have examined management's assertion that [*identify the assertion—for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX is presented in accordance with the ABC criteria set forth in Note 1*]. XYZ Company's management is responsible for the assertion. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting [*identify the subject matter—for example, XYZ Company's schedule of investment returns*] and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the assertion.*]

In our opinion, the schedule referred to above, presents, in all material respects, [*identify the subject matter—for example, the investment returns of XYZ Company for the year ended December 31, 20XX*] based on [*identify criteria—for example, the ABC criteria set forth in Note 1*].

[*Signature*]

[*Date*]

Example 4

This is an examination report on subject matter. Although suitable criteria exist, use of the report is restricted because the criteria are available only to specified parties. (See paragraph .34.) A written assertion has been obtained from the responsible party.

Independent Accountant's Report

We have examined the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX. XYZ Company's management is responsible for the schedule of investment returns. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting [*identify the subject matter—for example, XYZ Company's schedule of investment returns*] and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the assertion.*]

In our opinion, the schedule referred to above, presents, in all material respects, [*identify the subject matter—for example, the investment returns of XYZ Company for the year ended December 31, 20XX*] based on the ABC criteria referred to in the investment management agreement between XYZ Company and DEF Investment Managers, Ltd., dated November 15, 20X1.

This report is intended solely for the information and use of XYZ Company and [*identify other specified parties—for example, DEF Investment Managers, Ltd.*] and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

Example 5

This is an examination report with a qualified opinion because conditions exist that, individually or in combination, result in one or more material misstatements or deviations from the criteria; the report is for general use. The report pertains to subject matter for which suitable criteria exist and are available to all users through inclusion in a clear manner in the presentation of the subject matter. (See paragraphs .78 to .83 for guidance on restricting the use of the report when criteria are available only to specified parties.) A written assertion has been obtained from the responsible party.

Independent Accountant's Report

We have examined the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX. XYZ Company's management is responsible for the schedule of investment returns. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting [*identify the subject matter—for example, XYZ Company's schedule of investment returns*] and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Our examination disclosed the following [*describe condition(s) that, individually or in the aggregate, resulted in a material misstatement or deviation from the criteria*].

In our opinion, except for the material misstatement [*or deviation from the criteria*] described in the preceding paragraph, the schedule referred to above, presents, in all material respects, [*identify the subject matter—for example, the investment returns of XYZ Company for the year ended December 31, 20XX*] based on [*identify criteria—for example, the ABC criteria set forth in Note 1*].

[*Signature*]

[*Date*]

Example 6

This is an examination report that contains a disclaimer of opinion because of a scope restriction. (See paragraph .74 for reporting guidance when there is a scope restriction.) The report pertains to subject matter for which suitable criteria exist and are available to all users through inclusion in a clear manner in the presentation of the subject matter.

Independent Accountant's Report

We were engaged to examine the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX. XYZ Company's management is responsible for the schedule of investment returns.

[*Scope paragraph should be omitted.*]

[*Include paragraph to describe scope restrictions.*]

Because of the restriction on the scope of our examination discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on whether the schedule referred to above presents, in all material respects, [*identify the subject matter—for example, the investment returns of XYZ Company for the year ended December 31, 20XX*] based on [*identify criteria—for example, the ABC criteria set forth in Note 1*].

[*Signature*]

[*Date*]

Example 7

This is an examination report on subject matter that is the responsibility of a party other than the client. The report is restricted as to use since a written assertion has not been provided by the responsible party. (See paragraph .78.) The subject matter pertains to criteria that are suitable and are available to the client.

Independent Accountant's Report

To the Board of Directors

DEF Company:

We have examined the [*identify the subject matter—for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX*]. XYZ Company's management is responsible for the schedule of investment returns. XYZ management did not provide us a written assertion about their schedule of investment returns for the year ended December 31, 20XX. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting [*identify the subject matter—for example, XYZ Company's schedule of investment returns*] and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the subject matter.*]

In our opinion, the schedule referred to above presents, in all material respects, [*identify the subject matter—for example, the investment returns of XYZ Company for the year ended December 31, 20XX*] based on [*identify criteria—for example, the ABC criteria set forth in Note 1*].

This report is intended solely for the information and use of the management and board of directors of DEF Company and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 11, January 2002.]

.115

Appendix B

Review Reports

Example 1

This is a standard review report on subject matter for general use. The report pertains to subject matter for which suitable criteria exist and are available to all users through inclusion in a clear manner in the presentation of the subject matter. (See paragraphs .78 to .83 for guidance on restricting the use of the report when criteria are available only to specified parties.) A written assertion has been obtained from the responsible party.

Independent Accountant's Report

We have reviewed the [*identify the subject matter—for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX*]. XYZ Company's management is responsible for the schedule of investment returns.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on [*identify the subject matter—for example, XYZ Company's schedule of investment returns*]. Accordingly, we do not express such an opinion.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the subject matter.*]

Based on our review, nothing came to our attention that caused us to believe that the [*identify the subject matter—for example, schedule of investment returns of XYZ Company for the year ended December 31, 20XX*] is not presented, in all material respects, in conformity with [*identify the criteria—for example, the ABC criteria set forth in Note 1*].

[*Signature*]

[*Date*]

Example 2

This is a review report on subject matter that is the responsibility of a party other than the client. This review report is restricted as to use since a written assertion has not been provided by the responsible party. (See paragraph .78.) The subject matter pertains to criteria that are suitable and are available to the client.

Independent Accountant's Report

To the Board of Directors

DEF Company:

We have reviewed [*identify the subject matter—for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX*]. XYZ Company's management is responsible for the schedule of investment returns. XYZ Company's management did not provide us a written assertion about their schedule of investment returns for the year ended December 31, 20XX.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on [*identify the subject matter—for example, XYZ Company's schedule of investment returns*]. Accordingly, we do not express such an opinion.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the subject matter.*]

Based on our review, nothing came to our attention that caused us to believe that [*identify the subject matter—for example, the schedule of investment returns of XYZ Company for the year ended December 31, 20XX*] is not presented, in all material respects, in conformity with [*identify the criteria—for example, the ABC criteria set forth in Note 1*].

This report is intended solely for the information and use of the management and board of directors of DEF Company and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

Example 3

This is a review report on an assertion. Although suitable criteria exist for the subject matter, the report is restricted as to use since the criteria are available only to specified parties; if the criteria are available as described in paragraph .33 (*a*) to (*d*), the paragraph restricting the use of the report would be omitted. A written assertion has been obtained from the responsible party.

Independent Accountant's Report

We have reviewed management's assertion that [*identify the assertion—for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX is presented in accordance with the ABC criteria referred to in Note 1*]. XYZ Company's management is responsible for the assertion.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assertion. Accordingly, we do not express such an opinion.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the assertion.*]

Based on our review, nothing came to our attention that caused us to believe that management's assertion referred to above is not fairly stated, in all material respects, based on [*identify the criteria—for example, the ABC criteria referred to in the investment management agreement between XYZ Company and DEF Investment Managers, Ltd., dated November 15, 20X1*].

This report is intended solely for the information and use of XYZ Company and [*identify other specified parties—for example, DEF Investment Managers, Ltd.*] and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Standards for Attestation Engagements No. 11, January 2002.]

AT Section 9101

Attest Engagements: Attest Engagements Interpretations of Section 101

1. Defense Industry Questionnaire on Business Ethics and Conduct [1]

.01 *Question*—Certain defense contractors have made a commitment to adopt and implement six principles of business ethics and conduct contained in the *Defense Industry Initiatives on Business Ethics and Conduct (Initiatives)*. One of those principles concerns defense contractors' public accountability for their commitment to the Initiatives. That public accountability begins by the contractor completing an annual *Public Accountability Questionnaire (Questionnaire)*.

.02 Each of the participating signatory companies (signatories) completes a questionnaire concerning certain policies, procedures and programs which were to have been in place during the reporting period. The public accountability process requires signatories to perform internal audits and to provide officer certifications as to whether the responses to the *Questionnaire* are current and accurate.

.03 Alternatively, a defense contractor may request its independent public accountant (practitioner) to examine or review its responses to the *Questionnaire* for the purpose of expressing a conclusion about the appropriateness of those responses in a report. Would such an engagement be an attest engagement under section 101, *Attest Engagements*?

.04 *Interpretation*—Section 101 states that the attestation standards apply when a certified public accountant in the practice of public accounting is engaged to issue or does issue an examination, a review, or an agreed-upon procedures report on subject matter, or an assertion about the subject matter that is the responsibility of another party. When a practitioner is engaged by a defense contractor to provide an examination or a review report on the contractor's written responses to the questionnaire, such an engagement involves subject matter that is the responsibility of the defense contractor. Consequently, section 101 applies to such engagements.

.05 *Question*—Section 101.23 specifies that "the practitioner shall perform the engagement only if he or she has reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users." What are the criteria against which such subject matter is to be evaluated and are such criteria suitable and available?

.06 *Interpretation*—The criteria for evaluating the defense contractor's responses are set forth primarily in the *Questionnaire* and the instructions thereto. The suitability of those criteria should be evaluated by assessing whether the criteria meet the characteristics discussed in section 101.24.

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[1] Information regarding the Defense Industry Initiative on Business Ethics and Conduct (DII) is available at DII's website http://www.dii.org.

.07 The criteria set forth in the *Questionnaire* and its instructions will, when properly followed, be suitable. Although these should provide suitable criteria, the *Questionnaire* and its instructions are not generally available. Therefore, the practitioner's report should normally be restricted. The availability requirement can be met if the defense contractor attaches the criteria to the presentation.

.08 *Question*—What is the nature of the procedures that should be applied to the *Questionnaire* responses?

.09 *Interpretation*—The objective of the procedures performed in either an examination or a review engagement is to obtain evidential matter that the defense contractor has designed and placed in operation policies and programs in a manner that supports the signatory's responses to each of the questions on the *Questionnaire* and that the policies and programs operated during the period covered by the *Questionnaire*. The objective does not include providing assurance about whether the defense contractor's policies and programs operated effectively to ensure compliance with the defense contractor's code of business ethics and conduct on the part of individual employees or about whether the defense contractor and its employees have complied with federal procurement laws. In an examination, the evidential matter should be sufficient to limit attestation risk to a level that is appropriately low for the high degree of assurance imparted by an examination report. In a review, this evidential matter should be sufficient to limit attestation risk to a moderate level.

.10 Examination procedures include obtaining evidential matter by reading relevant policies and programs, making inquiries of appropriate defense contractor personnel, inspecting documents and records, confirming defense contractor assertions with its employees or others, and observing activities. In an examination it will be necessary for a practitioner's procedures to go beyond simply reading relevant policies and programs and making inquiries of appropriate defense contractor personnel. Alternatively, review procedures are generally limited to reading relevant policies and procedures and making inquiries of appropriate defense contractor personnel. When applying examination or review procedures, the practitioner should assess the appropriateness (including the comprehensiveness) of the policies and programs supporting the signatory's responses to each of the questions on the *Questionnaire*.

.11 A particular defense contractor's policies and programs may vary from those of other defense contractors. As a result, evidential matter obtained from the procedures performed cannot be evaluated solely on a quantitative basis. Consequently, it is not practicable to establish only quantitative guidelines for determining the nature or extent of the evidential matter that is necessary to provide the assurance required in either an examination or a review. The qualitative aspects should also be considered.

.12 In determining the nature, timing, and extent of examination or review procedures, the practitioner should consider information obtained in the performance of other services for the defense contractor, for example, the audit of the defense contractor's financial statements. For multi-location defense contractors, whether policies and programs operated during the period should be evaluated for both the defense contractor's headquarters and for selected defense contracting locations. The practitioner may consider using the work of the defense contractor's internal auditors. The guidance in AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, may be useful in that consideration.

.13 Examination procedures, and in some instances review procedures, may require access to information involving specific instances of actual or alleged noncompliance with laws. An inability to obtain access to such information because of restrictions imposed by a defense contractor (for example, to protect attorney-client privilege) may constitute a scope limitation. Section 101.73 through .75 provides guidance in such situations. The practitioner should assess the effect of the inability to obtain access to such information on his or her ability to form a conclusion about whether the related policy or program operated during the period. If the defense contractor's reasons for not permitting access to the information are reasonable (for example, the information is the subject of litigation or a governmental investigation) and have been approved by an executive officer of the defense contractor, the occurrences of restricted access to information are few in number, and the practitioner has access to other information about that specific instance or about other instances that is sufficient to permit a conclusion to be formed about whether the related policy or program operated during the period, the practitioner ordinarily would conclude that it is not necessary to disclaim assurance.

.14 If the practitioner's scope of work has been restricted with respect to one or more questions, the practitioner should consider the implications of that restriction on the practitioner's ability to form a conclusion about other questions. In addition, as the nature or number of questions on which the defense contractor has imposed scope limitations increases in significance, the practitioner should consider whether to withdraw from the engagement.

.15 *Question*—What is the form of report that should be issued to meet the requirements of section 101?

.16 *Interpretation*—The standards of reporting in section 101 provide guidance about report content and wording and the circumstances that may require report modification. Appendix A and Appendix B [paragraphs .21 and .22] provide illustrative reports appropriate for various circumstances. Section 101.66 permits the practitioner to report directly on the subject matter or on management's assertion. In either case, the practitioner should ordinarily obtain a written assertion. An illustrative defense contractor assertion is also presented in Appendix A and Appendix B [paragraphs .21 and .22].

.17 The engagements addressed in this Interpretation do not include providing assurance about whether the defense contractor's policies and programs operated effectively to ensure compliance with the defense contractor's code of business ethics and conduct on the part of individual employees or about whether the defense contractor and its employees have complied with federal procurement laws. The practitioner's report should explicitly disclaim an opinion on the extent of such compliance.

.18 Because variations in individual performance and interpretation will affect the operation of the defense contractor's policies and programs during the period, adherence to all such policies and programs in every case may not be possible. In determining whether a reservation about a response in the *Questionnaire* is sufficiently significant to result in an opinion modified for an exception to that response, the practitioner should consider the nature, causes, patterns, and pervasiveness of the instances in which the policies and programs did not operate as designed and their implications for that response in the *Questionnaire*.

.19 When scope limitations have precluded the practitioner from forming an opinion on the responses to one or more questions, the practitioner's report should describe all such scope restrictions. If the defense contractor imposed

such a scope limitation after the practitioner had begun performing procedures, that fact should be stated in the report.

.20 A defense contractor may request the practitioner to communicate to management, the board of directors, or one of its committees, either orally or in writing, conditions noted that do not constitute significant reservations about the answers to the *Questionnaire* but that might nevertheless be of value to management. Agreed-upon arrangements between the practitioner and the defense contractor to communicate conditions noted may include, for example, the reporting of matters of less significance than those contemplated by the criteria, the existence of conditions specified by the defense contractor, the results of further investigation of matters noted to identify underlying causes, or suggestions for improvements in various policies or programs. Under these arrangements, the practitioner may be requested to visit specific locations, assess the effectiveness of specific policies or programs, or undertake specific procedures not otherwise planned. In addition, the practitioner is not precluded from communicating matters believed to be of value, even if no specific request has been made.

.21

Appendix A

Illustrative Defense Contractor Assertions and Examination Reports

Defense Industry Questionnaire on Business Ethics and Conduct

Illustration 1: Unqualified Opinion Unrestricted With Criteria Attached to the Presentation

Defense Contractor Assertion

Statement of Responses to the Defense Industry Questionnaire on *Business Ethics and Conduct for the period from* _____ *to* _____.

The affirmative responses in the accompanying *Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from* _____ *to* _____ are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Instructions and Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from _____ to _____.

Examination Report

Independent Accountant's Report

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from* _____ *to* _____, and the Questionnaire and responses attached thereto. XYZ Company's management is responsible for its responses to the Questionnaire. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence as to whether XYZ Company had policies and programs in operation during that period that support the affirmative responses to the *Questionnaire* and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Our examination procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's *Code of Business Ethics and Conduct* on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

In our opinion, the affirmative responses in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from* _____ *to* _____ referred to above

are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

Illustration 2: Unqualified Opinion; Report Modified for Negative Responses to Defense Contractor Assertion; Use of the Report is Restricted Because Criteria Are Available Only to Specified Parties

Defense Contractor Assertion

Statement of Responses to the Defense Industry Questionnaire on *Business Ethics and Conduct for the period from* _____ *to* _____.

The affirmative responses in the accompanying *Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from* _____ *to* _____ are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire. Negative responses indicate that the Company did not have policies and programs in operation during that period with respect to those areas.

Attachments: None

(The responses could include an explanation of negative responses if the defense contractor so desired.)

Examination Report

Independent Accountant's Report

To the Board of Directors of the XYZ Company

We have examined the XYZ Company's *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from* _____ *to* _____. XYZ Company's management is responsible for its responses to the Questionnaire. Our responsibility is to express an opinion based on our examination.

[*Standard Scope Paragraph*]

In our opinion, the affirmative responses in the Questionnaire referred to above are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire. The negative responses to Questions _____and _____in the Questionnaire indicate that the Company did not have policies and programs in operation during the period with respect to those areas.

This report is intended solely for the information and use of the XYZ Company and [*identify other specified parties—for example,* the Defense Industry Initiative] and is not intended to be and should not be used by anyone other than these specified parties.

Illustration 3: Opinion Modified for Exception on Certain Response

Defense Contractor Assertion

Statement of Responses to the Defense Industry Questionnaire on *Business Ethics and Conduct for the period from* _____ *to* _____.

The affirmative responses in the accompanying *Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from* _____ *to* _____, are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth

in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from _____ to _____.

Examination Report

Independent Accountant's Report

To the Board of Directors of the XYZ Company

[*Standard Introductory and Scope Paragraphs*]

Management believes that an appropriate mechanism exists for informing employees of the results of any follow-up into their charges of violations of the Company's Code of Business Ethics and Conduct, and has accordingly answered Question 12 in the affirmative. That mechanism consists principally of distributing newspaper articles and press releases of violations of federal procurement laws that have been voluntarily reported to the appropriate governmental agencies. We do not believe that such a mechanism is sufficient, inasmuch as it does not provide follow-up information on violations reported by employees that are not deemed reportable to a governmental agency. Consequently, in our opinion, the affirmative response to Question 12 in the Questionnaire is not appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

In our opinion, except for the response to Question 12 as discussed in the preceding paragraph, the affirmative responses in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from _____ to _____* referred to above are appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire.

Illustration 4: Opinion Modified for Exception on a Certain Response; Report also Modified for Negative Responses

Defense Contractor Assertion

Statement of Responses to the *Defense Industry Questionnaire on Business Ethics and Conduct for the period from _____ to _____.*

The affirmative responses in the accompanying *Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from _____ to _____* are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire. Negative responses indicate that the Company did not have policies and programs in operation during that period with respect to those areas.

Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from _____ to _____.

(The responses could include an explanation of negative responses if the defense contractor so desired.)

Examination Report

Independent Accountant's Report

To the Board of Directors of the XYZ Company

[*Standard Introductory and Scope Paragraphs*]

Management believes that an appropriate mechanism exists for letting employees know of the results of any follow-up into their charges of violations of the Company's Code of Business Ethics and Conduct, and has accordingly answered Question 12 in the affirmative. That mechanism consists principally of distributing newspaper articles and press releases of violations of federal procurement laws that have been voluntarily reported to the appropriate governmental agencies. We do not believe that such a mechanism is sufficient, inasmuch as it does not provide follow-up information on violations reported by employees that are not deemed reportable to a governmental agency. Consequently, in our opinion, the affirmative response to Question 12 in the Questionnaire is not appropriately presented in conformity with the criteria set forth in the Defense Industry Initiatives on Business Ethics and Conduct, including the Questionnaire.

In our opinion, except for the response to Question 12 as discussed in the preceding paragraph, the affirmative responses in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from* _____ *to* _____ referred to above are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire. The negative responses to Questions _____ and _____ in the Questionnaire indicate that the Company did not have policies and programs in operation during the period with respect to those areas.

Illustration 5: Opinion Disclaimed on Certain Responses Because of Scope Restrictions Imposed by Client

Defense Contractor Assertion

Statement of Responses to the Defense Industry Questionnaire on *Business Ethics and Conduct for the period from* _____ *to* _____.

The affirmative responses in the accompanying *Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from* _____ *to* _____ are based on policies and programs in operation for that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

Attachments:

Defense Industry Initiatives on Business Ethics and Conduct

Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from _____ to _____.

Examination Report

Independent Accountant's Report

To the Board of Directors of the XYZ Company

[*Standard Introductory Paragraph*]

Except as described below, our examination was conducted in accordance with attestation standards established by the American Institute of Certified

Public Accountants and, accordingly, included examining, on a test basis, evidence as to whether XYZ Company had policies and programs in operation during that period that support the affirmative responses to the *Questionnaire*. We believe that our examination provides a reasonable basis for our opinion. Our examination procedures were not designed, however, to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's *Code of Business Ethics and Conduct* on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws, and we do not express an opinion or any other form of assurance thereon.

We were not permitted to read relevant documents and files or interview appropriate employees to determine that the affirmative answers to Questions 6, 7, and 8 are appropriate. The nature of those questions precluded us from satisfying ourselves as to the appropriateness of those answers by means of other examination procedures.

In our opinion, the affirmative responses to Questions 1 through 5 and 9 through 17 in the Questionnaire accompanying the *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from* _____*to* _____referred to above are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire. Because of the matters discussed in the preceding paragraph, the scope of our work was not sufficient to express, and we do not express, an opinion on the appropriateness of the affirmative responses to Questions 6, 7, and 8 in the Questionnaire.

.22

Appendix B

Illustrative Defense Contractor Assertion and Review Report Restricted Because Criteria Are Available Only To Specified Parties

Defense Industry Questionnaire on Business Ethics and Conduct

Defense Contractor Assertion

Statement of Responses to the Defense Industry Questionnaire on *Business Ethics and Conduct for the period from* _____*to* _____.

The affirmative responses in the accompanying *Questionnaire on Business Ethics and Conduct with Responses by the XYZ Company for the period from* _____*to* _____are based on policies and programs in operation during that period and are appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

Attachments: None

Review Report

Independent Accountant's Report

To the Board of Directors of the XYZ Company

We have reviewed the XYZ Company's *Statement of Responses to the Defense Industry Questionnaire on Business Ethics and Conduct for the period from* _____*to* _____. XYZ Company's management is responsible for the Statement of Responses to the Defense Industry Questionnaire on Business Ethics.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the affirmative responses in the Questionnaire. Accordingly, we do not express such an opinion. Additionally, our review was not designed to evaluate whether the aforementioned policies and programs operated effectively to ensure compliance with the Company's *Code of Business Ethics and Conduct* on the part of individual employees or to evaluate the extent to which the Company or its employees have complied with federal procurement laws and we do not express an opinion or any other form of assurance thereon.

Based on our review, nothing came to our attention that caused us to believe that the affirmative responses in the Questionnaire referred to above are not appropriately presented in conformity with the criteria set forth in the *Defense Industry Initiatives on Business Ethics and Conduct*, including the Questionnaire.

This report is intended solely for the information and use of the XYZ Company and [*identify other specified parties—for example,* the Defense Industry Initiative] and is not intended to be and should not be used by anyone other than these specified parties.

[Issue Date: August, 1987; Amended: February, 1989; Modified: May, 1989; Revised: January, 2001.]

2. Responding to Requests for Reports on Matters Relating to Solvency

.23 *Question*—Lenders, as a requisite to the closing of certain secured financings in connection with leveraged buyouts (LBOs), recapitalizations and certain other financial transactions, have sometimes requested written assurance from an accountant regarding the prospective borrower's solvency and related matters.[2] The lender is concerned that such financings not be considered to include a fraudulent conveyance or transfer under the Federal Bankruptcy Code[3] or the relevant state fraudulent conveyance or transfer statute.[4] If the financing is subsequently determined to have included a fraudulent conveyance or transfer, repayment obligations and security interests may be set aside or subordinated to the claims of other creditors.

.24 May a practitioner provide assurance concerning "matters relating to solvency" as hereinafter defined?

.25 *Interpretation*—No. For reasons set forth below, a practitioner should not provide any form of assurance, through examination, review or agreed-upon procedures engagements, that an entity

- Is not insolvent at the time the debt is incurred or would not be rendered insolvent thereby.
- Does not have unreasonably small capital.
- Has the ability to pay its debts as they mature.

In the context of particular transactions other terms are sometimes used or defined by the parties as equivalents of or substitutes for the terms listed above (e.g., fair salable value of assets exceeds liabilities). These terms, and those matters listed above, are hereinafter referred to as "matters relating to solvency." The prohibition extends to providing assurance concerning all such terms.

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[2] While this interpretation describes requests from secured lenders and summarizes the potential effects of fraudulent conveyance or transfer laws upon such lenders, the interpretation is not limited to requests from lenders. All requests for assurance on matters relating to solvency are governed by this interpretation.

[3] Section 548 of the Federal Bankruptcy Code defines fraudulent transfers and obligations as follows:

> "The trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
>
> "(1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer occurred or such obligation was incurred, indebted; or
> "(2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
> "(2)(B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
> "(2)(B)(ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
> "(2)(B)(iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured." (Bankruptcy Law Reporter, 3 vols. [Chicago: Commerce Clearing House, 1986], vol. 1, 1339).

[4] State fraudulent conveyance or transfer statutes such as the Uniform Fraudulent Conveyance Act and the Uniform Fraudulent Transfer Act reflect substantially similar provisions. These state laws may be employed absent a declaration of bankruptcy or by a bankruptcy trustee under section 544(1) of the Federal Bankruptcy Code. While the statute of limitations varies from state to state, in some states financing transactions may be vulnerable to challenge for up to six years from closing.

.26 The third general attestation standard states that the practitioner shall perform the engagement only if he or she has reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users. Suitable criteria must have each of the following attributes:

- Objectivity—Criteria should be free from bias.
- Measurability—Criteria should permit reasonably consistent measurements, qualitative or quantitative, of subject matter.
- Completeness—Criteria should be sufficiently complete so those relevant factors that would alter a conclusion about subject matter are not omitted.
- Relevance—Criteria should be relevant to the subject matter.

In addition, the second general attestation standard states that the engagement shall be performed by a practitioner or practitioners having adequate knowledge of the subject matter.

.27 The matters relating to solvency mentioned in paragraph .23 above are subject to legal interpretation under, and varying legal definition in, the Federal Bankruptcy Code and various state fraudulent conveyance and transfer statutes. Because these matters are not clearly defined in an accounting sense, and are therefore subject to varying interpretations, they do not provide the practitioner with suitable criteria required to evaluate the subject matter or an assertion under the third general attestation standard. In addition, lenders are concerned with legal issues on matters relating to solvency and the practitioner is generally unable to evaluate or provide assurance on these matters of legal interpretation. Therefore, practitioners are precluded from giving any form of assurance on matters relating to solvency or any financial presentation of matters relating to solvency.

.28 Under existing AICPA standards, the practitioner may provide a client with various professional services that may be useful to the client in connection with a financing. These services include:

- Audit of historical financial statements.
- Review of historical financial information (a review in accordance with AU section 722, *Interim Financial Information*, of interim financial information or in accordance with AR section 100, *Compilation and Review of Financial Statements*).
- Examination or review of pro forma financial information (section 401, *Reporting on Pro Forma Financial Information*).
- Examination or compilation of prospective financial information (section 301, *Financial Forecasts and Projections*).

.29 In addition, under existing AICPA attestation standards (section 201), the practitioner can provide the client and lender with an agreed-upon procedures report. In such an engagement, a client and lender may request that specified procedures be applied to various financial presentations, such as historical financial information, pro forma financial information and prospective financial information, which can be useful to a client or lender in connection with a financing.

.30 The practitioner should be aware that certain of the services described in paragraph .28 require that the practitioner have an appropriate level of knowledge of the entity's accounting and financial reporting practices and its internal control. This has ordinarily been obtained by the practitioner auditing historical financial statements of the entity for the most recent annual period or by otherwise obtaining an equivalent knowledge base. When considering acceptance of an engagement relating to a financing, the practitioner should consider whether he or she can perform these services without an equivalent knowledge base.

.31 A report on agreed-upon procedures should not provide any assurances on matters relating to solvency or any financial presentation of matters relating to solvency (e.g., fair salable value of assets less liabilities or fair salable value of assets less liabilities, contingent liabilities and other commitments). A practitioner's report on the results of applying agreed-upon procedures should contain the report elements set forth in section 201.31 (or section 301.55 if applying agreed upon procedures to prospective financial information). The practitioner's report on the results of applying agreed-upon procedures should:

- State that the service has been requested in connection with a financing (no reference should be made to any solvency provisions in the financing agreement).
- State that no representations are provided regarding questions of legal interpretation.
- State that no assurance is provided concerning the borrower's (1) solvency, (2) adequacy of capital or (3) ability to pay its debts.
- State that the procedures should not be taken to supplant any additional inquiries and procedures that the lender should undertake in its consideration of the proposed financing.
- Where applicable, state that an audit of recent historical financial statements has previously been performed and that no audit of any historical financial statements for a subsequent period has been performed. In addition, if any services have been performed pursuant to paragraph .28, they may be referred to.

.32 The report ordinarily is dated at or shortly before the closing date. The financing agreement ordinarily specifies the date, often referred to as the cutoff date, to which the report is to relate (for example, a date three business days before the date of the report). The report should state that the inquiries and other procedures carried out in connection with the report did not cover the period from the cutoff date to the date of the report.

.33 The practitioner might consider furnishing the client with a draft of the agreed-upon procedures report. The draft report should deal with all matters expected to be covered in the terms expected to be used in the final report. The draft report should be identified as a draft in order to avoid giving the impression that the procedures described therein have been performed. This practice of furnishing a draft report at an early point permits the practitioner to make clear to the client and lender what they may expect the accountant to furnish and gives them an opportunity to change the financing agreement or the agreed-upon procedures if they so desire.

[Issue Date: May, 1988; Amended: February, 1993; Revised: January, 2001.]

3. Applicability of Attestation Standards to Litigation Services

.34 *Question*—Section 101, *Attest Engagements*, paragraph .04, provides an example of a litigation service provided by practitioners that would not be considered an attest engagement as defined by section 101. When does section 101 not apply to litigation service engagements?

.35 *Interpretation*—Section 101 does not apply to litigation services that involve pending or potential formal legal or regulatory proceedings before a "trier of fact"[5] in connection with the resolution of a dispute between two or more parties in any of the following circumstances when the:

a. Practitioner has not been engaged to issue and does not issue an examination, a review, or an agreed-upon procedures report on subject matter, or an assertion about the subject matter that is the responsibility of another party.

b. Service comprises being an expert witness.

c. Service comprises being a trier of fact or acting on behalf of one.

d. Practitioner's work under the rules of the proceedings is subject to detailed analysis and challenge by each party to the dispute.

e. Practitioner is engaged by an attorney to do work that will be protected by the attorney's work product privilege and such work is not intended to be used for other purposes.

When performing such litigation services, the practitioner should comply with Rule 201, *General Standards*, of the AICPA *Code of Professional Conduct* [ET section 201.01].

.36 *Question*—When does section 101 apply to litigation service engagements?

.37 *Interpretation*—Section 101 applies to litigation service engagements only when the practitioner is engaged to issue or does issue an examination, a review, or an agreed-upon procedures report on subject matter, or an assertion about the subject matter, that is the responsibility of another party.

.38 *Question*—Section 101.04*c* provides the following example of litigation service engagements that are not considered attest engagements:

> Services performed in accordance with the Statement on Standards for Consulting Services, such as. . . . engagements in which a practitioner is engaged to testify as an expert witness in accounting, auditing, taxation, or other matters, given certain stipulated facts.

What does the term "stipulated facts" as used in section 101.04*c* mean?

.39 *Interpretation*—The term "stipulated facts" as used in section 101.04*c* means facts or assumptions that are specified by one or more parties to a dispute

[5] A "trier of fact" in this section means a court, regulatory body, or government authority; their agents; a grand jury; or an arbitrator or mediator of the dispute.

to serve as the basis for the development of an expert opinion. It is not used in its typical legal sense of facts agreed to by all parties involved in a dispute.

.40 *Question*—Does Attest Engagements Interpretation No. 2, *Responding to Requests for Reports on Matters Relating to Solvency* (paragraphs .23 through .33), prohibit a practitioner from providing expert testimony, as described in section 101.04*c* before a "trier of fact" on matters relating to solvency?

.41 *Interpretation*—No. Matters relating to solvency mentioned in paragraph .25 are subject to legal interpretation under, and varying legal definition in, the Federal Bankruptcy Code and various state fraudulent conveyance and transfer statutes. Because these matters are not clearly defined in an accounting sense, and therefore subject to varying interpretations, they do not provide the practitioner with the suitable criteria required to evaluate the assertion. Thus, Attest Engagements Interpretation No. 2, *Responding to Requests for Reports on Matters Relating to Solvency* (paragraphs .23 through .33), prohibits a practitioner from providing any form of assurance in reporting upon examination, review or agreed-upon procedures engagements about matters relating to solvency (as defined in paragraph .25).

.42 However, a practitioner who is involved with pending or potential formal legal or regulatory proceedings before a "trier of fact" in connection with the resolution of a dispute between two or more parties may provide an expert opinion or consulting advice about matters relating to solvency. The prohibition in paragraphs .23 through .33 does not apply in such engagements because as part of the legal or regulatory proceedings, each party to the dispute has the opportunity to analyze and challenge the legal definition and interpretation of the matters relating to solvency and the criteria the practitioner uses to evaluate matters related to solvency. Such services are not intended to be used by others who do not have the opportunity to analyze and challenge such definitions and interpretations.

[Issue Date: July, 1990; Revised: January, 2001.]

4. Providing Access to or Copies of Attest Documentation to a Regulator

.43 *Question*—Interpretation No. 1 to AU section 339, *Audit Documentation*, entitled "Providing Access to or Copies of Audit Documentation to a Regulator" (AU section 9339.01–.15), contains guidance relating to providing access to or copies of audit documentation to a regulator. Is this guidance applicable to an attest engagement when a regulator requests access to or copies of the attest documentation?

.44 *Interpretation*—Yes. The guidance in Interpretation No. 1 to AU section 339 (AU section 9339.01–.15) is applicable in these circumstances; however, the letter to a regulator should be tailored to meet the individual engagement characteristics or the purpose of the regulatory request, for example, a quality control review. Illustrative letters for an examination engagement performed in accordance with section 601, *Compliance Attestation*, and an agreed-upon procedures engagement performed in accordance with section 201, *Agreed-Upon Procedures Engagements*, follow.

.45 Illustrative letter for examination engagement:

Illustrative Letter to Regulator[6]

[*Date*]

[*Name and Address of Regulatory Agency*]

Your representatives have requested access to our attest documentation in connection with our engagement to examine (*identify the subject matter examined or restate management's assertion*). It is our understanding that the purpose of your request is (*state purpose*: for example, "to facilitate your regulatory examination").[7]

Our examination was conducted in accordance with attestation standards[8] established by the American Institute of Certified Public Accountants, the objective of which is to form an opinion as to whether the subject matter (or management's assertion) is fairly stated, in all material respects, based on (*identify criteria*). Under these standards, we have the responsibility to plan and perform our examination to provide a reasonable basis for our opinion and to exercise due professional care in the performance of our examination. Our examination is subject to the inherent risk that material noncompliance, if it exists, would not be detected. In addition, our examination does not address the possibility that material noncompliance may occur in the future. Also, our use of professional judgment and the assessments of attestation risk and materiality for the purpose of our examination means that matters may have existed that would have been assessed differently by you. Our examination does not provide a legal determination on (*name of entity*)'s compliance with specified requirements.

The attest documentation was prepared for the purpose of providing the principal support for our opinion on (*name of entity*)'s compliance and to aid in the performance and supervision of our examination. The attest documentation is the principal record of attest procedures performed, information obtained, and conclusions reached in the examination. The procedures that we performed were limited to those we considered necessary under attestation standards[9] established by the American Institute of Certified Public Accountants to provide us with reasonable basis for our opinion. Accordingly, we make no representation as to the sufficiency or appropriateness, for your purposes, of either the procedures or information in our attest documentation. In addition, any notations, comments, and individual conclusions appearing on any of the attest documentation do not stand alone and should not be read as an opinion on any part of management's assertion or the related subject matter.

Our examination was conducted for the purpose stated above and was not planned or performed in contemplation of your (*state purpose*: for example, "regulatory examination"). Therefore, items of possible interest to you may not have been specifically addressed. Accordingly, our examination, and the attest documentation prepared in connection therewith, should not supplant other inquiries and procedures that should be undertaken by the (*name of regulatory*

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[6] The practitioner should appropriately modify this letter when the engagement has been conducted in accordance with Statements on Standards for Attestation Engagements and also in accordance with additional attest requirements specified by a regulatory agency (for example, the requirements specified in *Government Auditing Standards* issued by the Comptroller General of the United States).

[7] If the practitioner is not required by law, regulation, or engagement contract to provide a regulator access to the attest documentation but otherwise intends to provide such access (see AU section 9339.11–.15), the letter should include a statement that: "Management of (*name of entity*) has authorized us to provide you access to our attest documentation for (*state purpose*)."

[8] Refer to footnote 6.

[9] Refer to footnote 6.

agency) for the purpose of monitoring and regulating (*name of entity*). In addition, we have not performed any procedures since the date of our report with respect to the subject matter (*or management's assertion related thereto*), and significant events or circumstances may have occurred since that date.

The attest documentation constitutes and reflects work performed or information obtained by us in the course of our examination. The documents contain trade secrets and confidential commercial and financial information of our firm and (*name of entity*) that is privileged and confidential, and we expressly reserve all rights with respect to disclosures to third parties. Accordingly, we request confidential treatment under the Freedom of Information Act or similar laws and regulations when requests are made for the attest documentation or information contained therein or any documents created by the (*name of regulatory agency*) containing information derived there from. We further request that written notice be given to our firm before distribution of the information in the attest documentation (or copies thereof) to others, including other governmental agencies, except when such distribution is required by law or regulation.[10]

[*If it is expected that copies will be requested, add the following*:

Any copies of our attest documentation we agree to provide you will contain a legend "Confidential Treatment Requested by (*name of practitioner, address, telephone number*)."]

[*Firm signature*]

.46 Example letter for agreed-upon procedures engagements:

Illustrative Letter to Regulator[11]

[*Date*]

[*Name and Address of Regulatory Agency*]

Your representatives have requested access to our attest documentation in connection with our engagement to perform agreed-upon procedures on (*identify the subject matter or restate management's assertion*). It is our understanding that the purpose of your request is (*state purpose:* for example, "to facilitate your regulatory examinations").[12]

Our agreed-upon procedures engagement was conducted in accordance with attestation standards[13] established by the American Institute of Certified Public Accountants. Under these standards, we have the responsibility to perform the agreed-upon procedures to provide a reasonable basis for the findings expressed in our report. We were not engaged to, and did not, perform an examination, the objective of which would be to form an opinion on (*identify the subject matter or management's assertion*). Our engagement is subject to the inherent risk that material misstatement of (*identify the subject matter or management's*

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[10] This illustrative paragraph may not in and of itself be sufficient to gain confidential treatment under the rules and regulations of certain regulatory agencies. The practitioner should consider tailoring this paragraph to the circumstances after consulting the regulations of each applicable regulatory agency and, if necessary, consult with legal counsel regarding the specific procedures and requirements necessary to gain confidential treatment.

[11] The practitioner should appropriately modify this letter when the engagement has been conducted in accordance with Statements on Standards for Attestation Engagements and also in accordance with additional attest requirements specified by a regulatory agency (for example, the requirements specified in *Government Auditing Standards* issued by the Comptroller General of the United States).

[12] If the practitioner is not required by law, regulation or engagement contract to provide a regulator access to the attest documentation but otherwise intends to provide such access (see AU section 9339.11–.15) the letter should include a statement that: "Management of (*name of entity*) has authorized us to provide you access to our attest documentation for (*state purpose*)."

[13] Refer to footnote 6.

assertion), if it exists, would not be detected. (*The practitioner may add the following:* "In addition, our engagement does not address the possibility that material misstatement of (*identify the subject matter or management's assertion*) may occur in the future.") The procedures that we performed were limited to those agreed to by the specified users, and the sufficiency of these procedures is solely the responsibility of the specified users of the report. Further, our engagement does not provide a legal determination on (*name of entity*)'s compliance with specified requirements.

The attest documentation was prepared to document agreed-upon procedures applied, information obtained, and findings reached in the engagement. Accordingly, we make no representation, for your purposes, as to the sufficiency or appropriateness of the information in our attest documentation. In addition, any notations, comments, and individual findings appearing on any of the attest documentation should not be read as an opinion on management's assertion or the related subject matter, or any part thereof.

Our engagement was performed for the purpose stated above and was not performed in contemplation of your (*state purpose*: for example, "regulatory examination"). Therefore, items of possible interest to you may not have been specifically addressed. Accordingly, our engagement, and the attest documentation prepared in connection therewith, should not supplant other inquiries and procedures that should be undertaken by the (*name of regulatory agency*) for the purpose of monitoring and regulating (*name of client*). In addition, we have not performed any procedures since the date of our report with respect to the subject matter or management's assertion related thereto, and significant events or circumstances may have occurred since that date.

The attest documentation constitutes and reflects procedures performed or information obtained by us in the course of our engagement. The documents contain trade secrets and confidential commercial and financial information of our firm and (*name of client*) that is privileged and confidential, and we expressly reserve all rights with respect to disclosures to third parties. Accordingly, we request confidential treatment under the Freedom of Information Act or similar laws and regulations when requests are made for the attest documentation or information contained therein or any documents created by the (*name of regulatory agency*) containing information derived therefrom. We further request that written notice be given to our firm before distribution of the information in the attest documentation (or copies thereof) to others, including other governmental agencies, except when such distribution is required by law or regulation.[14]

[*If it is expected that copies will be requested, add the following:*

Any copies of our attest documentation we agree to provide you will contain a legend "Confidential Treatment Requested by (*name of practitioner, address, telephone number*)."]

[*Firm signature*]

[Issue Date: May, 1996; Revised: January, 2001; Revised: January, 2002.]

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[14] This illustrative paragraph may not in and of itself be sufficient to gain confidential treatment under the rules and regulations of certain regulatory agencies. The practitioner should consider tailoring this paragraph to the circumstances after consulting the regulations of each applicable regulatory agency and, if necessary, consult with legal counsel regarding the specific procedures and requirements necessary to gain confidential treatment.

AT Section 201

Agreed-Upon Procedures Engagements

Source: SSAE No. 10; SSAE No. 11.

Effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001, unless otherwise indicated.

Introduction and Applicability

.01 This section sets forth attestation standards and provides guidance to a practitioner concerning performance and reporting in all agreed-upon procedures engagements, except as noted in paragraph .02. A practitioner also should refer to the following sections of this Statement on Standards for Attestation Engagements (SSAE), which provide additional guidance for certain types of agreed-upon procedures engagements:

a. Section 301, *Financial Forecasts and Projections*

b. Section 601, *Compliance Attestation*

.02 This section does not apply to the following:[1]

a. Situations in which an auditor reports on specified compliance requirements based solely on an audit of financial statements, as addressed in AU section 623, *Special Reports,* paragraphs .19–.21

b. Engagements for which the objective is to report in accordance with AU section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, unless the terms of the engagement specify that the engagement be performed pursuant to SSAEs

c. Circumstances covered by AU section 324, *Service Organizations*, paragraph .58, when the service auditor is requested to apply substantive procedures to user transactions or assets at the service organization, and he or she makes specific reference in his or her service auditor's report to having carried out designated procedures (However, this section applies when the service auditor provides a separate report on the performance of agreed-upon procedures in an attestation engagement.)

d. Engagements covered by AU section 634, *Letters for Underwriters and Certain Other Requesting Parties*

e. Certain professional services that would not be considered as falling under this section as described in section 101, *Attest Engagements*, paragraph .04.

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[1] The Attest Interpretation, "Responding to Requests for Reports on Matters Relating to Solvency" (section 9101.23–.33), prohibits the performance of any attest engagements concerning matters of solvency or insolvency.

Agreed-Upon Procedures Engagements

.03 An agreed-upon procedures engagement is one in which a practitioner is engaged by a client to issue a report of findings based on specific procedures performed on subject matter. The client engages the practitioner to assist specified parties in evaluating subject matter or an assertion as a result of a need or needs of the specified parties.[2] Because the specified parties require that findings be independently derived, the services of a practitioner are obtained to perform procedures and report his or her findings. The specified parties and the practitioner agree upon the procedures to be performed by the practitioner that the specified parties believe are appropriate. Because the needs of the specified parties may vary widely, the nature, timing, and extent of the agreed-upon procedures may vary as well; consequently, the specified parties assume responsibility for the sufficiency of the procedures since they best understand their own needs. In an engagement performed under this section, the practitioner does not perform an examination or a review, as discussed in section 101, and does not provide an opinion or negative assurance.[3] (See paragraph .24.) Instead, the practitioner's report on agreed-upon procedures should be in the form of procedures and findings. (See paragraph .31.)

.04 As a consequence of the role of the specified parties in agreeing upon the procedures performed or to be performed, a practitioner's report on such engagements should clearly indicate that its use is restricted to those specified parties.[4] Those specified parties, including the client, are hereinafter referred to as *specified parties*.

Standards

.05 The general, fieldwork, and reporting standards for attestation engagements as set forth in section 101, together with interpretive guidance regarding their application as addressed throughout this section, should be followed by the practitioner in performing and reporting on agreed-upon procedures engagements.

Conditions for Engagement Performance

.06 The practitioner may perform an agreed-upon procedures attest engagement provided that—

a. The practitioner is independent.

b. One of the following conditions is met.

(1) The party wishing to engage the practitioner is responsible for the subject matter, or has a reasonable basis for providing a written assertion about the subject matter when the nature of the subject matter is such that a responsible party does not otherwise exist.

(2) The party wishing to engage the practitioner is not responsible for the subject matter but is able to provide the practitioner, or have a third party who is responsible for

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[2] See paragraphs .08 and .09 for a discussion of subject matter and assertion.

[3] For guidance on expressing an opinion on specified elements, accounts, or items of a financial statement based on an audit, see AU section 623.11–.18.

[4] See section 101.78–.83 for additional guidance regarding restricted-use reports.

the subject matter provide the practitioner with evidence of the third party's responsibility for the subject matter.

c. The practitioner and the specified parties agree upon the procedures performed or to be performed by the practitioner.

d. The specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes.

e. The specific subject matter to which the procedures are to be applied is subject to reasonably consistent measurement.

f. Criteria to be used in the determination of findings are agreed upon between the practitioner and the specified parties.

g. The procedures to be applied to the specific subject matter are expected to result in reasonably consistent findings using the criteria.

h. Evidential matter related to the specific subject matter to which the procedures are applied is expected to exist to provide a reasonable basis for expressing the findings in the practitioner's report.

i. Where applicable, the practitioner and the specified parties agree on any materiality limits for reporting purposes. (See paragraph .25.)

j. Use of the report is restricted to the specified parties.

k. For agreed-upon procedures engagements on prospective financial information, the prospective financial statements include a summary of significant assumptions. (See section 301.52.)

Agreement on and Sufficiency of Procedures

.07 To satisfy the requirements that the practitioner and the specified parties agree upon the procedures performed or to be performed and that the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes, ordinarily the practitioner should communicate directly with and obtain affirmative acknowledgment from each of the specified parties. For example, this may be accomplished by meeting with the specified parties or by distributing a draft of the anticipated report or a copy of an engagement letter to the specified parties and obtaining their agreement. If the practitioner is not able to communicate directly with all of the specified parties, the practitioner may satisfy these requirements by applying any one or more of the following or similar procedures.

- Compare the procedures to be applied to written requirements of the specified parties.
- Discuss the procedures to be applied with appropriate representatives of the specified parties involved.
- Review relevant contracts with or correspondence from the specified parties.

The practitioner should not report on an engagement when specified parties do not agree upon the procedures performed or to be performed and do not take responsibility for the sufficiency of the procedures for their purposes. (See paragraph .36 for guidance on satisfying these requirements when the practitioner is requested to add other parties as specified parties after the date of completion of the agreed-upon procedures.)

Subject Matter and Related Assertions

.08 The subject matter of an agreed-upon procedures engagement may take many different forms and may be at a point in time or covering a period of time. In an agreed-upon procedures engagement, it is the specific subject matter to which the agreed-upon procedures are to be applied using the criteria selected. Even though the procedures are agreed upon between the practitioner and the specified parties, the subject matter and the criteria must meet the conditions set forth in the third general standard. (See section 101.23 and .24.) The criteria against which the specific subject matter needs to be measured may be recited within the procedures enumerated or referred to in the practitioner's report.

.09 An assertion is any declaration or set of declarations about whether the subject matter is based on or in conformity with the criteria selected. A written assertion is generally not required in an agreed-upon procedures engagement unless specifically required by another attest standard (for example, see section 601.11). If, however, the practitioner requests the responsible party to provide an assertion, the assertion may be presented in a representation letter or another written communication from the responsible party, such as in a statement, narrative description, or schedule appropriately identifying what is being presented and the point in time or the period of time covered.

Establishing an Understanding With the Client

.10 The practitioner should establish an understanding with the client regarding the services to be performed. When the practitioner documents the understanding through a written communication with the client (an *engagement letter*), such communication should be addressed to the client, and in some circumstances also to all specified parties. Matters that might be included in such an understanding include the following:

- The nature of the engagement
- Identification of the subject matter (or the assertion related thereto), the responsible party, and the criteria to be used
- Identification of specified parties (See paragraph .36.)
- Specified parties' acknowledgment of their responsibility for the sufficiency of the procedures
- Responsibilities of the practitioner (See paragraphs .12 to .14 and .40.)
- Reference to attestation standards established by the American Institute of Certified Public Accountants (AICPA)
- Agreement on procedures by enumerating (or referring to) the procedures (See paragraphs .15 to .18.)
- Disclaimers expected to be included in the practitioner's report
- Use restrictions
- Assistance to be provided to the practitioner (See paragraphs .22 and .23.)
- Involvement of a specialist (See paragraphs .19 to .21.)
- Agreed-upon materiality limits (See paragraph .25.)

Nature, Timing, and Extent of Procedures

Responsibility of the Specified Parties

.11 Specified parties are responsible for the sufficiency (nature, timing, and extent) of the agreed-upon procedures because they best understand their own needs. The specified parties assume the risk that such procedures might be insufficient for their purposes. In addition, the specified parties assume the risk that they might misunderstand or otherwise inappropriately use findings properly reported by the practitioner.

Practitioner's Responsibility

.12 The responsibility of the practitioner is to carry out the procedures and report the findings in accordance with the general, fieldwork, and reporting standards as discussed and interpreted in this section. The practitioner assumes the risk that misapplication of the procedures may result in inappropriate findings being reported. Furthermore, the practitioner assumes the risk that appropriate findings may not be reported or may be reported inaccurately. The practitioner's risks can be reduced through adequate planning and supervision and due professional care in performing the procedures, determining the findings, and preparing the report.

.13 The practitioner should have adequate knowledge in the specific subject matter to which the agreed-upon procedures are to be applied. He or she may obtain such knowledge through formal or continuing education, practical experience, or consultation with others.[5]

.14 The practitioner has no responsibility to determine the differences between the agreed-upon procedures to be performed and the procedures that the practitioner would have determined to be necessary had he or she been engaged to perform another form of attest engagement. The procedures that the practitioner agrees to perform pursuant to an agreed-upon procedures engagement may be more or less extensive than the procedures that the practitioner would determine to be necessary had he or she been engaged to perform another form of engagement.

Procedures to Be Performed

.15 The procedures that the practitioner and specified parties agree upon may be as limited or as extensive as the specified parties desire. However, mere reading of an assertion or specified information about the subject matter does not constitute a procedure sufficient to permit a practitioner to report on the results of applying agreed-upon procedures. In some circumstances, the procedures agreed upon evolve or are modified over the course of the engagement. In general, there is flexibility in determining the procedures as long as the specified parties acknowledge responsibility for the sufficiency of such procedures for their purposes. Matters that should be agreed upon include the nature, timing, and extent of the procedures.

.16 The practitioner should not agree to perform procedures that are overly subjective and thus possibly open to varying interpretations. Terms of uncertain meaning (such as general review, limited review, check, or test) should not

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[5] Section 601.19 and .20 provide guidance about obtaining an understanding of certain requirements in an agreed-upon procedures engagement on compliance.

be used in describing the procedures unless such terms are defined within the agreed-upon procedures. The practitioner should obtain evidential matter from applying the agreed-upon procedures to provide a reasonable basis for the finding or findings expressed in his or her report, but need not perform additional procedures outside the scope of the engagement to gather additional evidential matter.

.17 Examples of appropriate procedures include the following:

- Execution of a sampling application after agreeing on relevant parameters
- Inspection of specified documents evidencing certain types of transactions or detailed attributes thereof
- Confirmation of specific information with third parties
- Comparison of documents, schedules, or analyses with certain specified attributes
- Performance of specific procedures on work performed by others (including the work of internal auditors—see paragraphs .22 and .23)
- Performance of mathematical computations

.18 Examples of inappropriate procedures include the following:

- Mere reading of the work performed by others solely to describe their findings
- Evaluating the competency or objectivity of another party
- Obtaining an understanding about a particular subject
- Interpreting documents outside the scope of the practitioner's professional expertise

Involvement of a Specialist[6]

.19 The practitioner's education and experience enable him or her to be knowledgeable about business matters in general, but he or she is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. In certain circumstances, it may be appropriate to involve a specialist to assist the practitioner in the performance of one or more procedures. The following are examples.

- An attorney might provide assistance concerning the interpretation of legal terminology involving laws, regulations, rules, contracts, or grants.
- A medical specialist might provide assistance in understanding the characteristics of diagnosis codes documented in patient medical records.
- An environmental engineer might provide assistance in interpreting environmental remedial action regulatory directives that may affect the agreed-upon procedures applied to an environmental liabilities account in a financial statement.

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[6] A *specialist* is a person (or firm) possessing skill or knowledge in a particular field other than the attest function. As used herein, a specialist does not include a person employed by the practitioner's firm who participates in the attest engagement.

- A geologist might provide assistance in distinguishing between varying physical characteristics of a generic minerals group related to information to which the agreed-upon procedures are applied.

.20 The practitioner and the specified parties should explicitly agree to the involvement of the specialist in assisting a practitioner in the performance of an agreed-upon procedures engagement. This agreement may be reached when obtaining agreement on the procedures performed or to be performed and acknowledgment of responsibility for the sufficiency of the procedures, as discussed in paragraph .07. The practitioner's report should describe the nature of the assistance provided by the specialist.

.21 A practitioner may agree to apply procedures to the report or work product of a specialist that does not constitute assistance by the specialist to the practitioner in an agreed-upon procedures engagement. For example, the practitioner may make reference to information contained in a report of a specialist in describing an agreed-upon procedure. However, it is inappropriate for the practitioner to agree to merely read the specialist's report solely to describe or repeat the findings, or to take responsibility for all or a portion of any procedures performed by a specialist or the specialist's work product.

Internal Auditors and Other Personnel

.22 The agreed-upon procedures to be enumerated or referred to in the practitioner's report are to be performed entirely by the practitioner except as discussed in paragraphs .19 to .21.[7] However, internal auditors or other personnel may prepare schedules and accumulate data or provide other information for the practitioner's use in performing the agreed-upon procedures. Also, internal auditors may perform and report separately on procedures that they have carried out. Such procedures may be similar to those that a practitioner may perform under this section.

.23 A practitioner may agree to perform procedures on information documented in the working papers of internal auditors. For example, the practitioner may agree to—

- Repeat all or some of the procedures.
- Determine whether the internal auditors' working papers contain documentation of procedures performed and whether the findings documented in the working papers are presented in a report by the internal auditors.

However, it is inappropriate for the practitioner to—

- Agree to merely read the internal auditors' report solely to describe or repeat their findings.
- Take responsibility for all or a portion of any procedures performed by internal auditors by reporting those findings as the practitioner's own.
- Report in any manner that implies shared responsibility for the procedures with the internal auditors.

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[7] AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, does not apply to agreed-upon procedures engagements.

Findings

.24 A practitioner should present the results of applying agreed-upon procedures to specific subject matter in the form of findings. The practitioner should not provide negative assurance about whether the subject matter or the assertion is fairly stated based on the criteria. For example, the practitioner should not include a statement in his or her report that "nothing came to my attention that caused me to believe that the [*identify subject matter*] is not presented based on [or the assertion is not fairly stated based on] [*identify criteria*]."

.25 The practitioner should report all findings from application of the agreed-upon procedures. The concept of materiality does not apply to findings to be reported in an agreed-upon procedures engagement unless the definition of materiality is agreed to by the specified parties. Any agreed-upon materiality limits should be described in the practitioner's report.

.26 The practitioner should avoid vague or ambiguous language in reporting findings. Examples of appropriate and inappropriate descriptions of findings resulting from the application of certain agreed-upon procedures follow.

Procedures Agreed Upon	***Appropriate Description of Findings***	***Inappropriate Description of Findings***
Inspect the shipment dates for a sample (agreed-upon) of specified shipping documents, and determine whether any such dates were subsequent to December 31, 20XX.	No shipment dates shown on the sample of shipping documents were subsequent to December 31, 20XX.	Nothing came to my attention as a result of applying that procedure.
Calculate the number of blocks of streets paved during the year ended September 30, 20XX, shown on contractors' certificates of project completion; compare the resultant number to the number in an identified chart of performance statistics.	The number of blocks of streets paved in the chart of performance statistics was Y blocks more than the number calculated from the contractors' certificates of project completion.	The number of blocks of streets paved approximated the number of blocks included in the chart of performance statistics.
Calculate the rate of return on a specified investment (according to an agreed-upon formula) and verify that the resultant percentage agrees to the percentage in an identified schedule.	No exceptions were found as a result of applying the procedure.	The resultant percentage approximated the predetermined percentage in the identified schedule.

Procedures Agreed Upon	*Appropriate Description of Findings*	*Inappropriate Description of Findings*
Inspect the quality standards classification codes in identified performance test documents for products produced during a specified period; compare such codes to those shown in an identified computer printout.	All classification codes inspected in the identified documents were the same as those shown in the computer printout except for the following: [*List all exceptions.*]	All classification codes appeared to comply with such performance documents.
Trace all outstanding checks appearing on a bank reconciliation as of a certain date to checks cleared in the bank statement of the subsequent month.	All outstanding checks appearing on the bank reconciliation were cleared in the subsequent month's bank statement except for the following: [*List all exceptions.*]	Nothing came to my attention as a result of applying the procedure.
Compare the amounts of the invoices included in the "over ninety days" column shown in an identified schedule of aged accounts receivable of a specific customer as of a certain date to the amount and invoice date shown on the outstanding invoice and determine whether or not the invoice dates precede the date indicated on the schedule by more than ninety days.	All outstanding invoice amounts agreed with the amounts shown on the schedule in the "over ninety days" column, and the dates shown on such invoices preceded the date indicated on the schedule by more than ninety days.	The outstanding invoice amounts agreed within approximation of the amounts shown on the schedule in the "over ninety days" column, and nothing came to our attention that the dates shown on such invoices preceded the date indicated on the schedule by more than ninety days.

Working Papers

[.27–.30] [Paragraphs deleted by the issuance of Statement on Standards for Attestation Engagements No. 11, January 2002.][8–9]

[8–9] [Footnotes deleted by the issuance of Statement on Standards for Attestation Engagements No. 11, January 2002.]

Reporting

Required Elements

.31 The practitioner's report on agreed-upon procedures should be in the form of procedures and findings. The practitioner's report should contain the following elements:

a. A title that includes the word *independent*

b. Identification of the specified parties (See paragraph .36.)

c. Identification of the subject matter[10] (or the written assertion related thereto) and the character of the engagement

d. Identification of the responsible party

e. A statement that the subject matter is the responsibility of the responsible party

f. A statement that the procedures performed were those agreed to by the specified parties identified in the report

g. A statement that the agreed-upon procedures engagement was conducted in accordance with attestation standards established by the AICPA

h. A statement that the sufficiency of the procedures is solely the responsibility of the specified parties and a disclaimer of responsibility for the sufficiency of those procedures

i. A list of the procedures performed (or reference thereto) and related findings (The practitioner should not provide negative assurance—see paragraph .24.)

j. Where applicable, a description of any agreed-upon materiality limits (See paragraph .25.)

k. A statement that the practitioner was not engaged to and did not conduct an examination[11,12] of the subject matter, the objective of which would be the expression of an opinion, a disclaimer of opinion on the subject matter, and a statement that if the practitioner

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[10] In some agreed-upon procedures engagements, the practitioner may be asked to apply agreed-upon procedures to more than one subject matter or assertion. In these engagements, the practitioner may issue one report that refers to all subject matter covered or assertions presented. (For example, see section 601.28.)

[11] If the practitioner also wishes to refer to a review, alternate wording would be as follows.

A statement that the practitioner was not engaged to and did not conduct an examination or a review of the subject matter, the objectives of which would be the expression of an opinion or limited assurance, a disclaimer of opinion on the subject matter, and a statement that if the practitioner had performed additional procedures, other matters might have come to his or her attention that would have been reported.

[12] If the subject matter consists of elements, accounts, or items of a financial statement, this statement may be worded as follows.

We were not engaged to and did not conduct an audit [*or a review*], the objective of which would be the expression of an opinion [*or limited assurance*] on the [*identify elements, accounts, or items of a financial statement*].

Accordingly, we do not express such an opinion [*or limited assurance*]. Alternatively, the wording may be the following.

These agreed-upon procedures do not constitute an audit [*or a review*] of financial statements or any part thereof, the objective of which is the expression of opinion [or limited assurance] on the financial statements or a part thereof.

had performed additional procedures, other matters might have come to his or her attention that would have been reported[13]

l. A statement of restrictions on the use of the report because it is intended to be used solely by the specified parties[14]

m. Where applicable, reservations or restrictions concerning procedures or findings as discussed in paragraphs .33, .35, .39, and .40

n. For an agreed-upon procedures engagement on prospective financial information, all items included in section 301.55

o. Where applicable, a description of the nature of the assistance provided by a specialist as discussed in paragraphs .19 through .21

p. The manual or printed signature of the practitioner's firm

q. The date of the report

Illustrative Report

.32 The following is an illustration of an agreed-upon procedures report.

Independent Accountant's Report on Applying Agreed-Upon Procedures

To the Audit Committees and Managements of ABC Inc. and XYZ Fund:

We have performed the procedures enumerated below, which were agreed to by the audit committees and managements of ABC Inc. and XYZ Fund, solely to assist you in evaluating the accompanying Statement of Investment Performance Statistics of XYZ Fund (prepared in accordance with the criteria specified therein) for the year ended December 31, 20X1. XYZ Fund's management is responsible for the statement of investment performance statistics. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

[*Include paragraphs to enumerate procedures and findings*.]

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on the accompanying Statement

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[13] When the practitioner consents to the inclusion of his or her report on an agreed-upon procedures engagement in a document or written communication containing the entity's financial statements, he or she should refer to AU section 504, *Association With Financial Statements*, or to Statement on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements*, as appropriate, for guidance on his or her responsibility pertaining to the financial statements. The practitioner should follow (*a*) AU section 504.04 when the financial statements of a public or nonpublic entity are audited (or reviewed in accordance with AU section 722, *Interim Financial Information*, or (*b*) AU section 504.05 when the financial statements of a public entity are unaudited. The practitioner should follow SSARS No. 1, paragraph 3 when (*a*) the financial statements of a nonpublic entity are reviewed or compiled or (*b*) the financial statements of a nonpublic entity are *not* reviewed or compiled and are not submitted by the accountant, as defined in SSARS No. 1, paragraph 1. (See section 101.82 and .83 for guidance when the practitioner combines or includes in a document a restricted-use report with a general-use report.) [Footnote revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Standards for Accounting and Review Services No. 9.]

[14] The purpose of the restriction on the use of the practitioner's report on applying agreed-upon procedures is to restrict its use to only those parties that have agreed upon the procedures performed and taken responsibility for the sufficiency of the procedures. Paragraph .36 describes the process for adding parties who were not originally contemplated in the agreed-upon procedures engagement.

of Investment Performance Statistics of XYZ Fund. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the audit committees and managements of ABC Inc. and XYZ Fund,[15] and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

Explanatory Language

.33 The practitioner also may include explanatory language about matters such as the following:

- Disclosure of stipulated facts, assumptions, or interpretations (including the source thereof) used in the application of agreed-upon procedures (For example, see section 601.26.)
- Description of the condition of records, controls, or data to which the procedures were applied
- Explanation that the practitioner has no responsibility to update his or her report
- Explanation of sampling risk

Dating of Report

.34 The date of completion of the agreed-upon procedures should be used as the date of the practitioner's report.

Restrictions on the Performance of Procedures

.35 When circumstances impose restrictions on the performance of the agreed-upon procedures, the practitioner should attempt to obtain agreement from the specified parties for modification of the agreed-upon procedures. When such agreement cannot be obtained (for example, when the agreed-upon procedures are published by a regulatory agency that will not modify the procedures), the practitioner should describe any restrictions on the performance of procedures in his or her report or withdraw from the engagement.

Adding Specified Parties (Nonparticipant Parties)

.36 Subsequent to the completion of the agreed-upon procedures engagement, a practitioner may be requested to consider the addition of another party as a specified party (*a nonparticipant party*). The practitioner may agree to add a nonparticipant party as a specified party, based on consideration of such factors as the identity of the nonparticipant party and the intended use of the report.[16] If the practitioner does agree to add the nonparticipant party, he or she should obtain affirmative acknowledgment, normally in writing, from the nonparticipant party agreeing to the procedures performed and of its taking responsibility for the sufficiency of the procedures. If the nonparticipant party

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[15] The report may list the specified parties or refer the reader to the specified parties listed elsewhere in the report.

[16] When considering whether to add a nonparticipant party, the guidance in AU section 530, *Dating of the Independent Auditor's Report*, paragraphs .06 and .07, may be helpful.

is added after the practitioner has issued his or her report, the report may be reissued or the practitioner may provide other written acknowledgment that the nonparticipant party has been added as a specified party. If the report is reissued, the report date should not be changed. If the practitioner provides written acknowledgment that the nonparticipant party has been added as a specified party, such written acknowledgment ordinarily should state that no procedures have been performed subsequent to the date of the report.

Written Representations

.37 A practitioner may find a representation letter to be a useful and practical means of obtaining representations from the responsible party. The need for such a letter may depend on the nature of the engagement and the specified parties. For example, section 601.68 requires a practitioner to obtain written representations from the responsible party in an agreed-upon procedures engagement related to compliance with specified requirements.

.38 Examples of matters that might appear in a representation letter from the responsible party include the following:

a. A statement acknowledging responsibility for the subject matter and, when applicable, the assertion

b. A statement acknowledging responsibility for selecting the criteria and for determining that such criteria are appropriate for their purposes

c. The assertion about the subject matter based on the criteria selected

d. A statement that all known matters contradicting the subject matter or the assertion and any communication from regulatory agencies affecting the subject matter or the assertion has been disclosed to the practitioner

e. Availability of all records relevant to the subject matter and the agreed-upon procedures

f. Other matters as the practitioner deems appropriate

.39 The responsible party's refusal to furnish written representations determined by the practitioner to be appropriate for the engagement constitutes a limitation on the performance of the engagement. In such circumstances, the practitioner should do one of the following.

a. Disclose in his or her report the inability to obtain representations from the responsible party.

b. Withdraw from the engagement.[17]

c. Change the engagement to another form of engagement.

Knowledge of Matters Outside Agreed-Upon Procedures

.40 The practitioner need not perform procedures beyond the agreed-upon procedures. However, in connection with the application of agreed-upon procedures, if matters come to the practitioner's attention by other means that significantly contradict the subject matter (or written assertion related thereto)

[17] For an agreed-upon procedures engagement performed pursuant to section 601, management's refusal to furnish all required representations also constitutes a limitation on the scope of the engagement that requires the practitioner to withdraw from the engagement.

referred to in the practitioner's report, the practitioner should include this matter in his or her report.[18] For example, if, during the course of applying agreed-upon procedures regarding an entity's internal control, the practitioner becomes aware of a material weakness by means other than performance of the agreed-upon procedure, the practitioner should include this matter in his or her report.

Change to an Agreed-Upon Procedures Engagement From Another Form of Engagement

.41 A practitioner who has been engaged to perform another form of attest engagement or a nonattest service engagement may, before the engagement's completion, be requested to change the engagement to an agreed-upon procedures engagement under this section. A request to change the engagement may result from a change in circumstances affecting the client's requirements, a misunderstanding about the nature of the original services or the alternative services originally available, or a restriction on the performance of the original engagement, whether imposed by the client or caused by circumstances.

.42 Before a practitioner who was engaged to perform another form of engagement agrees to change the engagement to an agreed-upon procedures engagement, he or she should consider the following:

a. The possibility that certain procedures performed as part of another type of engagement are not appropriate for inclusion in an agreed-upon procedures engagement

b. The reason given for the request, particularly the implications of a restriction on the scope of the original engagement or the matters to be reported

c. The additional effort required to complete the original engagement

d. If applicable, the reasons for changing from a general-use report to a restricted-use report

.43 If the specified parties acknowledge agreement to the procedures performed or to be performed and assume responsibility for the sufficiency of the procedures to be included in the agreed-upon procedures engagement, either of the following would be considered a reasonable basis for requesting a change in the engagement—

a. A change in circumstances that requires another form of engagement

b. A misunderstanding concerning the nature of the original engagement or the available alternatives

.44 In all circumstances, if the original engagement procedures are substantially complete or the effort to complete such procedures is relatively insignificant, the practitioner should consider the propriety of accepting a change in the engagement.

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[18] If the practitioner has performed (or has been engaged to perform) an audit of the entity's financial statements to which an element, account, or item of a financial statement relates and the auditor's report on such financial statements includes a departure from a standard report [see AU section 508, *Reports on Audited Financial Statements*], he or she should consider including a reference to the auditor's report and the departure from the standard report in his or her agreed-upon procedures report.

.45 If the practitioner concludes, based on his or her professional judgment, that there is reasonable justification to change the engagement, and provided he or she complies with the standards applicable to agreed-upon procedures engagements, the practitioner should issue an appropriate agreed-upon procedures report. The report should not include reference to either the original engagement or performance limitations that resulted in the changed engagement. (See paragraph .40.)

Combined Reports Covering Both Restricted-Use and General-Use Subject Matter or Presentations

.46 When a practitioner performs services pursuant to an engagement to apply agreed-upon procedures to specific subject matter as part of or in addition to another form of service, this section applies only to those services described herein; other Standards would apply to the other services. Other services may include an audit, review, or compilation of a financial statement, another attest service performed pursuant to the SSAEs, or a nonattest service.[19] Reports on applying agreed-upon procedures to specific subject matter may be combined with reports on such other services, provided the types of services can be clearly distinguished and the applicable Standards for each service are followed. See section 101.82 and .83, regarding restricting the use of the combined report.

Effective Date

.47 This section is effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001. Early application is permitted.

[19] See section 101.105–.107 for requirements relating to attest services provided as part of a consulting service engagement.

.48

Appendix

Additional Illustrative Reports

The following are additional illustrations of reporting on applying agreed-upon procedures to elements, accounts, or items of a financial statement.

1. Report in Connection With a Proposed Acquisition

Independent Accountant's Report
on Applying Agreed-Upon Procedures

To the Board of Directors and Management of X Company:

We have performed the procedures enumerated below, which were agreed to by the Board of Directors and Management of X Company, solely to assist you in connection with the proposed acquisition of Y Company as of December 31, 20XX. Y Company is responsible for its cash and accounts receivable records. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The procedures and the associated findings are as follows:

Cash

1. We obtained confirmation of the cash on deposit from the following banks, and we agreed the confirmed balance to the amount shown on the bank reconciliations maintained by Y Company. We mathematically checked the bank reconciliations and compared the resultant cash balances per book to the respective general ledger account balances.

Bank	*General Ledger Account Balances as of December 31, 20XX*
ABC National Bank	$5,000
DEF State Bank	3,776
XYZ Trust Company regular account	86,912
XYZ Trust Company payroll account	5,000
	$110,688

We found no exceptions as a result of the procedures.

Accounts Receivable

2. We added the individual customer account balances shown in an aged trial balance of accounts receivable (identified as Exhibit A) and compared the resultant total with the balance in the general ledger account.

We found no difference.

3. We compared the individual customer account balances shown in the aged trial balance of accounts receivable (Exhibit A) as of December 31, 19XX, to the balances shown in the accounts receivable subsidiary ledger.

   We found no exceptions as a result of the comparisons.

4. We traced the aging (according to invoice dates) for 50 customer account balances shown in Exhibit A to the details of outstanding invoices in the accounts receivable subsidiary ledger. The balances selected for tracing were determined by starting at the eighth item and selecting every fifteenth item thereafter.

   We found no exceptions in the aging of the amounts of the 50 customer account balances selected. The sample size traced was 9.8 percent of the aggregate amount of the customer account balances.

5. We mailed confirmations directly to the customers representing the 150 largest customer account balances selected from the accounts receivable trial balance, and we received responses as indicated below. We also traced the items constituting the outstanding customer account balance to invoices and supporting shipping documents for customers from which there was no reply. As agreed, any individual differences in a customer account balance of less than $300 were to be considered minor, and no further procedures were performed.

   Of the 150 customer balances confirmed, we received responses from 140 customers; 10 customers did not reply. No exceptions were identified in 120 of the confirmations received. The differences disclosed in the remaining 20 confirmation replies were either minor in amount (as defined above) or were reconciled to the customer account balance without proposed adjustment thereto. A summary of the confirmation results according to the respective aging categories is as follows.

	Accounts Receivable December 31, 20XX		
Aging Categories	*Customer Account Balances*	*Confirmations Requested*	*Confirmations Received*
Current	$156,000	$ 76,000	$ 65,000
Past due:			
Less than one month:	60,000	30,000	19,000
One to three months	36,000	18,000	10,000
Over three months	48,000	48,000	8,000
	$300,000	$172,000	$102,000

We were not engaged to and did not conduct an audit, the objective of which would be the expression of an opinion on cash and accounts receivable. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the board of directors and management of X Company and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

2. Report in Connection With Claims of Creditors

Independent Accountant's Report
on Applying Agreed-Upon Procedures

To the Trustee of XYZ Company:

We have performed the procedures described below, which were agreed to by the Trustee of XYZ Company, with respect to the claims of creditors solely to assist you in determining the validity of claims of XYZ Company as of May 31, 20XX, as set forth in the accompanying Schedule A. XYZ Company is responsible for maintaining records of claims submitted by creditors of XYZ Company. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the party specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The procedures and associated findings are as follows:

1. Compare the total of the trial balance of accounts payable at May 31, 20XX, prepared by XYZ Company, to the balance in the related general ledger account.

   The total of the accounts payable trial balance agreed with the balance in the related general ledger account.

2. Compare the amounts for claims received from creditors (as shown in claim documents provided by XYZ Company) to the respective amounts shown in the trial balance of accounts payable. Using the data included in the claims documents and in XYZ Company's accounts payable detail records, reconcile any differences found to the accounts payable trial balance.

   All differences noted are presented in column 3 of Schedule A. Except for those amounts shown in column 4 of Schedule A, all such differences were reconciled.

3. Obtain the documentation submitted by creditors in support of the amounts claimed and compare it to the following documentation in XYZ Company's files: invoices, receiving reports, and other evidence of receipt of goods or services.

   No exceptions were found as a result of these comparisons.

   We were not engaged to and did not conduct an audit, the objective of which would be the expression of an opinion on the claims of creditors set forth in the accompanying Schedule A. Accordingly, we do not express such an opinion. Had we performed additional

procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the Trustee of XYZ Company and is not intended to be and should not be used by anyone other than this specified party.

[*Signature*]

[*Date*]

AT Section 301

Financial Forecasts and Projections

Source: SSAE No. 10; SSAE No. 11.

Effective when the date of the practitioner's report is on or after June 1, 2001, unless otherwise indicated.

Introduction

.01 This section sets forth standards and provides guidance to practitioners who are engaged to issue or do issue examination (paragraphs .29 to .50), compilation (paragraphs .12 to .28), or agreed-upon procedures reports (paragraphs .51 to .56) on prospective financial statements.

.02 Whenever a practitioner (*a*) submits, to his or her client or others, prospective financial statements that he or she has assembled, or assisted in assembling, that are or reasonably might be expected to be used by another (third) party[1] or (*b*) reports on prospective financial statements that are, or reasonably might be expected to be used by another (third) party, the practitioner should perform one of the engagements described in the preceding paragraph. In deciding whether the prospective financial statements are or reasonably might be expected to be used by a third party, the practitioner may rely on either the written or oral representation of the responsible party, unless information comes to his or her attention that contradicts the responsible party's representation. If such third-party use of the prospective financial statements is not reasonably expected, the provisions of this section are not applicable unless the practitioner has been engaged to examine, compile, or apply agreed-upon procedures to the prospective financial statements.

.03 This section also provides standards for a practitioner who is engaged to examine, compile, or apply agreed-upon procedures to partial presentations. A partial presentation is a presentation of prospective financial information that excludes one or more of the items required for prospective financial statements as described in Appendix A [paragraph .68], "Minimum Presentation Guidelines."

.04 The practitioner who has been engaged to or does compile, examine, or apply agreed-upon procedures to a partial presentation should perform the engagement in accordance with the guidance in paragraphs .12 to .28 for compilations, .29 to .50 for examinations, and .51 to .56 for agreed-upon procedures, respectively, modified to reflect the nature of the presentation as discussed in paragraphs .03, .57, and .58.

.05 This section does not provide standards or procedures for engagements involving prospective financial statements used solely in connection with litigation support services. A practitioner may, however, look to these standards because they provide helpful guidance for many aspects of such engagements and may be referred to as useful guidance in such engagements. Litigation support services are engagements involving pending or potential formal legal proceedings before a trier of fact in connection with the resolution

[1] However, paragraph .59 permits an exception to this for certain types of budgets.

of a dispute between two or more parties, for example, when a practitioner acts as an expert witness. This exception is provided because, among other things, the practitioner's work in such proceedings is ordinarily subject to detailed analysis and challenge by each party to the dispute. This exception does not apply, however, if either of the following occur.

a. The practitioner is specifically engaged to issue or does issue an examination, a compilation, or an agreed-upon procedures report on prospective financial statements.

b. The prospective financial statements are for use by third parties who, under the rules of the proceedings, do not have the opportunity for analysis and challenge by each party to a dispute in a legal proceeding.

For example, creditors may not have such opportunities when prospective financial statements are submitted to them to secure their agreement to a plan of reorganization.

.06 In reporting on prospective financial statements, the practitioner may be called on to assist the responsible party in identifying assumptions, gathering information, or assembling the statements.[2] The responsible party is nonetheless responsible for the preparation and presentation of the prospective financial statements because the prospective financial statements are dependent on the actions, plans, and assumptions of the responsible party, and only it can take responsibility for the assumptions. Accordingly, the practitioner's engagement should not be characterized in his or her report or in the document containing his or her report as including "preparation" of the prospective financial statements. A practitioner may be engaged to prepare a financial analysis of a potential project where the engagement includes obtaining the information, making appropriate assumptions, and assembling the presentation. Such an analysis is not and should not be characterized as a forecast or projection and would not be appropriate for general use. However, if the responsible party reviewed and adopted the assumptions and presentation, or based its assumptions and presentation on the analysis, the practitioner could perform one of the engagements described in this section and issue a report appropriate for general use.

.07 The concept of materiality affects the application of this section to prospective financial statements as materiality affects the application of generally accepted auditing standards (GAAS) to historical financial statements. Materiality is a concept that is judged in light of the expected range of reasonableness of the information; therefore, users should not expect prospective information (information about events that have not yet occurred) to be as precise as historical information.

Definitions

.08 For the purposes of this section the following definitions apply.

a. *Prospective financial statements*—Either financial forecasts or financial projections including the summaries of significant assumptions and accounting policies. Although prospective financial statements may cover a period that has partially expired,

[2] Some of these services may not be appropriate if the practitioner is to be named as the person reporting on an examination in a filing with the Securities and Exchange Commission (SEC). SEC Release Nos. 33-5992 and 34-15305, "Disclosure of Projections of Future Economic Performance," state that for prospective financial statements filed with the commission, "a person should not be named as an outside reviewer if he actively assisted in the preparation of the projection."

statements for periods that have completely expired are not considered to be prospective financial statements. Pro forma financial statements and partial presentations are not considered to be prospective financial statements.[3]

b. *Partial presentation*—A presentation of prospective financial information that excludes one or more of the items required for prospective financial statements as described in Appendix A [paragraph .68], "Minimum Presentation Guidelines." Partial presentations are not ordinarily appropriate for general use; accordingly, partial presentations should be restricted for use by specified parties who will be negotiating directly with the responsible party.

c. *Financial forecast*—Prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and cash flows. A financial forecast is based on the responsible party's assumptions reflecting the conditions it expects to exist and the course of action it expects to take. A financial forecast may be expressed in specific monetary amounts as a single point estimate of forecasted results or as a range, where the responsible party selects key assumptions to form a range within which it reasonably expects, to the best of its knowledge and belief, the item or items subject to the assumptions to actually fall. When a forecast contains a range, the range is not selected in a biased or misleading manner, for example, a range in which one end is significantly less expected than the other. Minimum presentation guidelines for prospective financial statements are set forth in Appendix A [paragraph .68].

d. *Financial projection*—Prospective financial statements that present, to the best of the responsible party's knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operations, and cash flows. A financial projection is sometimes prepared to present one or more hypothetical courses of action for evaluation, as in response to a question such as, "What would happen if . . . ?" A financial projection is based on the responsible party's assumptions reflecting conditions it expects would exist and the course of action it expects would be taken, given one or more hypothetical assumptions. A projection, like a forecast, may contain a range. Minimum presentation guidelines for prospective financial statements are set forth in Appendix A [paragraph .68].

e. *Entity*—Any unit, existing or to be formed, for which financial statements could be prepared in accordance with generally accepted accounting principles (GAAP) or another comprehensive basis of accounting.[4] For example, an entity can be an individual, partnership, corporation, trust, estate, association, or governmental unit.

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[3] The objective of pro forma financial information is to show what the significant effects on the historical financial information might have been had a consummated or proposed transaction (or event) occurred at an earlier date. Although the transaction in question may be prospective, this section does not apply to such presentations because they are essentially historical financial statements and do not purport to be prospective financial statements. See section 401, *Reporting on Pro Forma Financial Information*.

[4] AU section 623, *Special Reports*, discusses comprehensive bases of accounting other than GAAP.

f. *Hypothetical assumption*—An assumption used in a financial projection to present a condition or course of action that is not necessarily expected to occur, but is consistent with the purpose of the projection.

g. *Responsible party*—The person or persons who are responsible for the assumptions underlying the prospective financial statements. The responsible party usually is management, but it can be persons outside of the entity who do not currently have the authority to direct operations (for example, a party considering acquiring the entity).

h. *Assembly*—The manual or computer processing of mathematical or other clerical functions related to the presentation of the prospective financial statements. Assembly does not refer to the mere reproduction and collation of such statements or to the responsible party's use of the practitioner's computer processing hardware or software.

i. *Key factors*—The significant matters on which an entity's future results are expected to depend. Such factors are basic to the entity's operations and thus encompass matters that affect, among other things, the entity's sales, production, service, and financing activities. Key factors serve as a foundation for prospective financial statements and are the bases for the assumptions.

Uses of Prospective Financial Statements

.09 Prospective financial statements are for either *general use* or *limited use*. *General use* of prospective financial statements refers to the use of the statements by persons with whom the responsible party is not negotiating directly, for example, in an offering statement of an entity's debt or equity interests. Because recipients of prospective financial statements distributed for general use are unable to ask the responsible party directly about the presentation, the presentation most useful to them is one that portrays, to the best of the responsible party's knowledge and belief, the expected results. Thus, only a financial forecast is appropriate for general use.

.10 *Limited use* of prospective financial statements refers to the use of prospective financial statements by the responsible party alone or by the responsible party and third parties with whom the responsible party is negotiating directly. Examples include use in negotiations for a bank loan, submission to a regulatory agency, and use solely within the entity. Third-party recipients of prospective financial statements intended for limited use can ask questions of the responsible party and negotiate terms directly with it. Any type of prospective financial statements that would be useful in the circumstances would normally be appropriate for limited use. Thus, the presentation may be a financial forecast or a financial projection.

.11 Because a financial projection is not appropriate for general use, a practitioner should not consent to the use of his or her name in conjunction with a financial projection that he or she believes will be distributed to those who will not be negotiating directly with the responsible party, for example, in an offering statement of an entity's debt or equity interests, unless the projection is used to supplement a financial forecast.

Compilation of Prospective Financial Statements

.12 A compilation of prospective financial statements is a professional service that involves the following:

a. Assembling, to the extent necessary, the prospective financial statements based on the responsible party's assumptions

b. Performing the required compilation procedures,[5] including reading the prospective financial statements with their summaries of significant assumptions and accounting policies, and considering whether they appear to be presented in conformity with AICPA presentation guidelines[6] and not obviously inappropriate

c. Issuing a compilation report

.13 A compilation is not intended to provide assurance on the prospective financial statements or the assumptions underlying such statements. Because of the limited nature of the practitioner's procedures, a compilation does not provide assurance that the practitioner will become aware of significant matters that might be disclosed by more extensive procedures, for example, those performed in an examination of prospective financial statements.

.14 The summary of significant assumptions is essential to the reader's understanding of prospective financial statements. Accordingly, the practitioner should not compile prospective financial statements that exclude disclosure of the summary of significant assumptions. Also, the practitioner should not compile a financial projection that excludes either (*a*) an identification of the hypothetical assumptions or (*b*) a description of the limitations on the usefulness of the presentation.

.15 The following standards apply to a compilation of prospective financial statements and to the resulting report.

a. The compilation should be performed by a person or persons having adequate technical training and proficiency to compile prospective financial statements.

b. Due professional care should be exercised in the performance of the compilation and the preparation of the report.

c. The work should be adequately planned, and assistants, if any, should be properly supervised.

d. Applicable compilation procedures should be performed as a basis for reporting on the compiled prospective financial statements. (See Appendix B [paragraph .69], "Training and Proficiency, Planning and Procedures Applicable to Compilations," for the procedures to be performed.)

e. The report based on the practitioner's compilation of prospective financial statements should conform to the applicable guidance in paragraphs .18 through .28.

.16 The practitioner should consider, after applying the procedures specified in paragraph .69, whether representations or other information he or she has received appear to be obviously inappropriate, incomplete, or otherwise misleading, and if so, the practitioner should attempt to obtain additional or revised information. If he or she does not receive such information, the practitioner should ordinarily withdraw from the compilation engagement.[7] (Note that the omission of disclosures, other than those relating to significant assumptions, would not require the practitioner to withdraw. See paragraph .26.)

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[5] See Appendix B [paragraph .69], subparagraph 5, for the required procedures.

[6] AICPA presentation guidelines are detailed in the AICPA Audit and Accounting Guide *Guide for Prospective Financial Information*.

[7] The practitioner need not withdraw from the engagement if the effect of such information on the prospective financial statement does not appear to be material.

Working Papers

[.17] [Paragraph deleted by the issuance of Statement on Standards for Attestation Engagements No. 11, January 2002.]

Reports on Compiled Prospective Financial Statements

.18 The practitioner's standard report on a compilation of prospective financial statements should include the following:

a. An identification of the prospective financial statements presented by the responsible party

b. A statement that the practitioner has compiled the prospective financial statements in accordance with attestation standards established by the American Institute of Certified Public Accountants

c. A statement that a compilation is limited in scope and does not enable the practitioner to express an opinion or any other form of assurance on the prospective financial statements or the assumptions

d. A caveat that the prospective results may not be achieved

e. A statement that the practitioner assumes no responsibility to update the report for events and circumstances occurring after the date of the report

f. The manual or printed signature of the practitioner's firm

g. The date of the compilation report

.19 The following is the form of the practitioner's standard report on the compilation of a forecast that does not contain a range.[8]

> We have compiled the accompanying forecasted balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 20XX, and for the year then ending, in accordance with attestation standards established by the American Institute of Certified Public Accountants.[9]
>
> A compilation is limited to presenting in the form of a forecast information that is the representation of management[10] and does not include evaluation of the support for the assumptions underlying the forecast. We have not examined the forecast and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.
>
> [*Signature*]
>
> [*Date*]

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[8] The forms of reports provided in this section are appropriate whether the presentation is based on GAAP or on another comprehensive basis of accounting.

[9] When the presentation is summarized as discussed in Appendix A [paragraph .68], this sentence might read, "We have compiled the accompanying summarized forecast of XYZ Company as of December 31, 20XX, and for the year then ending in accordance with attestation standards established by the American Institute of Certified Public Accountants."

[10] If the responsible party is other than management, the references to management in the standard reports provided in this section should be changed to refer to the party who assumes responsibility for the assumptions.

.20 When the presentation is a projection, the practitioner's compilation report should include the report elements set forth in paragraph .18. Additionally, the report should include a statement describing the special purpose for which the projection was prepared as well as a separate paragraph that restricts the use of the report because it is intended to be used solely by the specified parties. The following is the form of the practitioner's standard report on a compilation of a projection that does not contain a range.

> We have compiled the accompanying projected balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 20XX, and for the year then ending, in accordance with attestation standards established by the American Institute of Certified Public Accountants.[11] The accompanying projection was prepared for [*state special purpose, for example, "the purpose of negotiating a loan to expand XYZ Company's plant*"].
>
> A compilation is limited to presenting in the form of a projection information that is the representation of management and does not include evaluation of the support for the assumptions underlying the projection. We have not examined the projection and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, even if [*describe hypothetical assumption, for example, "the loan is granted and the plant is expanded,"*] there will usually be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.
>
> The accompanying projection and this report are intended solely for the information and use of [*identify specified parties, for example, "XYZ Company and DEF Bank"*] and is not intended to be and should not be used by anyone other than these specified parties.
>
> [*Signature*]
>
> [*Date*]

.21 When the prospective financial statements contain a range, the practitioner's standard report should also include a separate paragraph that states that the responsible party has elected to portray the expected results of one or more assumptions as a range. The following is an example of the separate paragraph to be added to the practitioner's report when he or she compiles prospective financial statements, in this case a forecast, that contain a range.

> As described in the summary of significant assumptions, management of XYZ Company has elected to portray forecasted [*describe financial statement element or elements for which the expected results of one or more assumptions fall within a range, and identify the assumptions expected to fall within a range, for example, "revenue at the amounts of $X,XXX and $Y,YYY, which is predicated upon occupancy rates of XX percent and YY percent of available apartments,"*] rather than as a single point estimate. Accordingly, the accompanying forecast presents forecasted financial position, results of operations, and cash flows [*describe one or more assumptions expected to fall within a range, for example, "at such occupancy rates."*] However, there is no assurance that the actual

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[11] When the presentation is summarized as discussed in Appendix A [paragraph .68], this sentence might read as follows.

> We have compiled the accompanying summarized projection of XYZ Company as of December 31, 20XX, and for the year then ending in accordance with attestation standards established by the American Institute of Certified Public Accountants.

results will fall within the range of [*describe one or more assumptions expected to fall within a range, for example, "occupancy rates"*] presented.

.22 The date of completion of the practitioner's compilation procedures should be used as the date of the report.

.23 A practitioner may compile prospective financial statements for an entity with respect to which he or she is not independent.[12] In such circumstances, the practitioner should specifically disclose his or her lack of independence; however, the reason for the lack of independence should not be described. When the practitioner is not independent, he or she may give the standard compilation report but should include the following sentence after the last paragraph.

We are not independent with respect to XYZ Company.

.24 Prospective financial statements may be included in a document that also contains historical financial statements and the practitioner's report thereon.[13] In addition, the historical financial statements that appear in the document may be summarized and presented with the prospective financial statements for comparative purposes.[14] An example of the reference to the practitioner's report on the historical financial statements when he or she audited, reviewed, or compiled those statements is presented below.

[*Concluding sentence of last paragraph*]

The historical financial statements for the year ended December 31, 20XX, [*from which the historical data are derived*] and our report thereon are set forth on pages XX-XX of this document.

.25 In some circumstances, a practitioner may wish to expand his or her report to emphasize a matter regarding the prospective financial statements. Such information may be presented in a separate paragraph of the practitioner's report. However, the practitioner should exercise care that emphasizing such a matter does not give the impression that he or she is expressing assurance or expanding the degree of responsibility he or she is taking with respect to such information.[15] For example, the practitioner should not include statements in his or her compilation report about the mathematical accuracy of the statements or their conformity with presentation guidelines.

Modifications of the Standard Compilation Report

.26 An entity may request a practitioner to compile prospective financial statements that contain presentation deficiencies or omit disclosures other than

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[12] In making a judgment about whether he or she is independent, the practitioner should be guided by the AICPA Code of Professional Conduct. Also, see the Auditing Interpretation "Applicability of Guidance on Reporting When Not Independent," (AU section 9504.19–.22).

[13] The practitioner's responsibility with respect to those historical financial statements upon which he or she is not engaged to perform a professional service is described in AU section 504, *Association With Financial Statements*, in the case of public entities, and Statement on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements*, paragraph 3, in the case of nonpublic entities. [Footnote revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Standards for Accounting and Review Services No. 9.]

[14] AU section 552, *Reporting on Condensed Financial Statements and Selected Financial Data*, discusses the practitioner's report where summarized financial statements are derived from audited statements that are not included in the same document.

[15] However, the practitioner may provide assurance on tax matters in order to comply with the requirements of regulations governing practice before the Internal Revenue Service (IRS) contained in 31 CFR pt. 10 (Treasury Department Circular No. 230).

those relating to significant assumptions. The practitioner may compile such prospective financial statements provided the deficiency or omission is clearly indicated in his or her report and is not, to his or her knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such statements.

.27 Notwithstanding the preceding, if the compiled prospective financial statements are presented on a comprehensive basis of accounting other than GAAP and do not include disclosure of the basis of accounting used, the basis should be disclosed in the practitioner's report.

.28 The following is an example of a paragraph that should be added to a report on compiled prospective financial statements, in this case a financial forecast, in which the summary of significant accounting policies has been omitted.

> Management has elected to omit the summary of significant accounting policies required by the guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants. If the omitted disclosures were included in the forecast, they might influence the user's conclusions about the Company's financial position, results of operations, and cash flows for the forecast period. Accordingly, this forecast is not designed for those who are not informed about such matters.

Examination of Prospective Financial Statements

.29 An examination of prospective financial statements is a professional service that involves—

a. Evaluating the preparation of the prospective financial statements.

b. Evaluating the support underlying the assumptions.

c. Evaluating the presentation of the prospective financial statements for conformity with AICPA presentation guidelines.[16]

d. Issuing an examination report.

.30 As a result of his or her examination, the practitioner has a basis for reporting on whether, in his or her opinion—

a. The prospective financial statements are presented in conformity with AICPA guidelines.

b. The assumptions provide a reasonable basis for the responsible party's forecast, or whether the assumptions provide a reasonable basis for the responsible party's projection given the hypothetical assumptions.

.31 The practitioner should follow the general, fieldwork, and reporting standards for attestation engagements as set forth in section 101, *Attest Engagements*, in performing an examination of prospective financial statements and reporting thereon. (See paragraph .70 for standards concerning such technical training and proficiency, planning the examination engagement, and the types of procedures a practitioner should perform to obtain sufficient evidence for his or her examination report.)

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[16] AICPA presentation guidelines are detailed in the AICPA Audit and Accounting Guide *Guide for Prospective Financial Information*.

Working Papers

[.32] [Paragraph deleted by the issuance of Statement on Standards for Attestation Engagements No. 11, January 2002.]

Reports on Examined Prospective Financial Statements

.33 The practitioner's standard report on an examination of prospective financial statements should include the following:

a. A title that includes the word *independent*

b. An identification of the prospective financial statements presented

c. An identification of the responsible party and a statement that the prospective financial statements are the responsibility of the responsible party

d. A statement that the practitioner's responsibility is to express an opinion on the prospective financial statements based on his or her examination

e. A statement that the examination of the prospective financial statements was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as the practitioner considered necessary in the circumstances

f. A statement that the practitioner believes that the examination provides a reasonable basis for his or her opinion

g. The practitioner's opinion that the prospective financial statements are presented in conformity with AICPA presentation guidelines and that the underlying assumptions provide a reasonable basis for the forecast or a reasonable basis for the projection given the hypothetical assumptions[17]

h. A caveat that the prospective results may not be achieved

i. A statement that the practitioner assumes no responsibility to update the report for events and circumstances occurring after the date of the report

j. The manual or printed signature of the practitioner's firm

k. The date of the examination report

.34 The following is the form of the practitioner's standard report on an examination of a forecast that does not contain a range.

Independent Accountant's Report

We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 20XX, and for the year then ending.[18] XYZ Company's management is responsible for the forecast. Our responsibility is to express an opinion on the forecast based on our examination.

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[17] The practitioner's report need not comment on the consistency of the application of accounting principles as long as the presentation of any change in accounting principles is in conformity with AICPA presentation guidelines as detailed in the AICPA Audit and Accounting Guide *Guide for Prospective Financial Information*.

[18] When the presentation is summarized as discussed in Appendix A [paragraph .68], this sentence might read, "We have examined the accompanying summarized forecast of XYZ Company as of December 31, 20XX, and for the year then ending."

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, the accompanying forecast is presented in conformity with guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

[*Signature*]

[*Date*]

.35 When a practitioner examines a projection, his or her opinion regarding the assumptions should be conditioned on the hypothetical assumptions; that is, he or she should express an opinion on whether the assumptions provide a reasonable basis for the projection given the hypothetical assumptions. The practitioner's examination report on a projection should include the report elements set forth in paragraph .33. Additionally, the report should include a statement describing the special purpose for which the projection was prepared as well a separate paragraph that restricts the use of the report because it is intended to be used solely by specified parties. The following is the form of the practitioner's standard report on an examination of a projection that does not contain a range.

Independent Accountant's Report

We have examined the accompanying projected balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 20XX, and for the year then ending.[19] XYZ Company's management is responsible for the projection, which was prepared for [*state special purpose, for example, "the purpose of negotiating a loan to expand XYZ Company's plant"*]. Our responsibility is to express an opinion on the projection based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the projection. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, the accompanying projection is presented in conformity with guidelines for presentation of a projection established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's projection [*describe the hypothetical assumption, for example, "assuming the granting of the requested loan for the purpose of expanding XYZ Company's plant as described in the summary of significant assumptions."*] However, even if [*describe hypothetical assumption,*

[19] When the presentation is summarized as discussed in Appendix A [paragraph .68], this sentence might read, "We have examined the accompanying summarized projection of XYZ Company as of December 31, 20XX, and for the year then ending."

for example, "the loan is granted and the plant is expanded,"], there will usually be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

The accompanying projection and this report are intended solely for the information and use of [*identify specified parties, for example, "XYZ Company and DEF National Bank"*] and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

.36 When the prospective financial statements contain a range, the practitioner's standard report should also include a separate paragraph that states that the responsible party has elected to portray the expected results of one or more assumptions as a range. The following is an example of the separate paragraph to be added to the practitioner's report when he or she examines prospective financial statements, in this case a forecast, that contain a range.

> As described in the summary of significant assumptions, management of XYZ Company has elected to portray forecasted [*describe financial statement element or elements for which the expected results of one or more assumptions fall within a range, and identify assumptions expected to fall within a range, for example, "revenue at the amounts of $X,XXX and $Y,YYY, which is predicated upon occupancy rates of XX percent and YY percent of available apartments,"*] rather than as a single point estimate. Accordingly, the accompanying forecast presents forecasted financial position, results of operations, and cash flows [*describe one or more assumptions expected to fall within a range, for example, "at such occupancy rates."*] However, there is no assurance that the actual results will fall within the range of [*describe one or more assumptions expected to fall within a range, for example, "occupancy rates"*] presented.

.37 The date of completion of the practitioner's examination procedures should be used as the date of the report.

Modifications to the Practitioner's Opinion[20]

.38 The following circumstances result in the following types of modified practitioner's report involving the practitioner's opinion.

a. If, in the practitioner's opinion, the prospective financial statements depart from AICPA presentation guidelines, he or she should express a qualified opinion (see paragraph .39) or an adverse opinion. (See paragraph .41.)[21] However, if the presentation departs from the presentation guidelines because it fails to disclose assumptions that appear to be significant, the practitioner should express an adverse opinion. (See paragraphs .41 and .42.)

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[20] Paragraphs .38 through .44 describe circumstances in which the practitioner's standard report on prospective financial statements may require modification. The guidance for modifying the practitioner's standard report is generally applicable to partial presentations. Also, depending on the nature of the presentation, the practitioner may decide to disclose that the partial presentation is not intended to be a presentation of financial position, results of operations, or cash flows. Illustrative reports on partial presentations may be found in the AICPA Audit and Accounting Guide *Guide for Prospective Financial Information*.

[21] However, the practitioner may issue the standard examination report on a financial forecast filed with the SEC that meets the presentation requirements of article XI of Regulation S-X.

b. If the practitioner believes that one or more significant assumptions do not provide a reasonable basis for the forecast, or a reasonable basis for the projection given the hypothetical assumptions, he or she should express an adverse opinion. (See paragraph .41.)

c. If the practitioner's examination is affected by conditions that preclude application of one or more procedures he or she considers necessary in the circumstances, he or she should disclaim an opinion and describe the scope limitation in his or her report. (See paragraph .43.)

.39 *Qualified Opinion*. In a qualified opinion, the practitioner should state, in a separate paragraph, all substantive reasons for modifying his or her opinion and describe the departure from AICPA presentation guidelines. His or her opinion should include the words "except" or "exception" as the qualifying language and should refer to the separate explanatory paragraph. The following is an example of an examination report on a forecast that is at variance with AICPA guidelines for presentation of a financial forecast.

Independent Accountant's Report

We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 20XX, and for the year then ending. XYZ Company's management is responsible for the forecast. Our responsibility is to express an opinion on the forecast based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast. We believe that our examination provides a reasonable basis for our opinion.

The forecast does not disclose significant accounting policies. Disclosure of such policies is required by guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants.

In our opinion, except for the omission of the disclosure of the significant accounting policies as discussed in the preceding paragraph, the accompanying forecast is presented in conformity with guidelines for a presentation of a forecast established by the American Institute of Certified Public Accountants and the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

[*Signature*]

[*Date*]

.40 Because of the nature, sensitivity, and interrelationship of prospective information, a reader would find a practitioner's report qualified for a measurement departure,[22] the reasonableness of the underlying assumptions, or a scope limitation difficult to interpret. Accordingly, the practitioner should

[22] An example of a measurement departure is the failure to capitalize a capital lease in a forecast where the historical financial statements for the prospective period are expected to be presented in conformity with GAAP.

not express his or her opinion about these items with language such as "except for . . ." or "subject to the effects of. . . ." Rather, when a measurement departure, an unreasonable assumption, or a limitation on the scope of the practitioner's examination has led him or her to conclude that he or she cannot issue an unqualified opinion, he or she should issue the appropriate type of modified opinion described in paragraphs .41 through .44.

.41 *Adverse Opinion.* In an adverse opinion the practitioner should state, in a separate paragraph, all of the substantive reasons for his or her adverse opinion. His or her opinion should state that the presentation is not in conformity with presentation guidelines and should refer to the explanatory paragraph. When applicable, his or her opinion paragraph should also state that, in the practitioner's opinion, the assumptions do not provide a reasonable basis for the prospective financial statements. An example of an adverse opinion on an examination of prospective financial statements is set forth below. In this case, a financial forecast was examined and the practitioner's opinion was that a significant assumption was unreasonable. The example should be revised as appropriate for a different type of presentation or if the adverse opinion is issued because the statements do not conform to the presentation guidelines.

Independent Accountant's Report

We have examined the accompanying forecasted balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 20XX, and for the year then ending. XYZ Company's management is responsible for the forecast. Our responsibility is to express an opinion on the forecast based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast. We believe that our examination provides a reasonable basis for our opinion.

As discussed under the caption "Sales" in the summary of significant forecast assumptions, the forecasted sales include, among other things, revenue from the Company's federal defense contracts continuing at the current level. The Company's present federal defense contracts will expire in March 20XX. No new contracts have been signed and no negotiations are under way for new federal defense contracts. Furthermore, the federal government has entered into contracts with another company to supply the items being manufactured under the Company's present contracts.

In our opinion, the accompanying forecast is not presented in conformity with guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants because management's assumptions, as discussed in the preceding paragraph, do not provide a reasonable basis for management's forecast. We have no responsibility to update this report for events or circumstances occurring after the date of this report.

[*Signature*]

[*Date*]

.42 If the presentation, including the summary of significant assumptions, fails to disclose assumptions that, at the time, appear to be significant, the practitioner should describe the assumptions in his or her report and express an adverse opinion. The practitioner should not examine a presentation that omits all disclosures of assumptions. Also, the practitioner should not examine a financial projection that omits (*a*) an identification of the hypothetical

assumptions or (*b*) a description of the limitations on the usefulness of the presentation.

.43 *Disclaimer of Opinion.* In a disclaimer of opinion, the practitioner's report should indicate, in a separate paragraph, the respects in which the examination did not comply with standards for an examination. The practitioner should state that the scope of the examination was not sufficient to enable him or her to express an opinion with respect to the presentation or the underlying assumptions, and his or her disclaimer of opinion should include a direct reference to the explanatory paragraph. The following is an example of a report on an examination of prospective financial statements, in this case a financial forecast, for which a significant assumption could not be evaluated.

Independent Accountant's Report

We were engaged to examine the accompanying forecasted balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 20XX, and for the year then ending. XYZ Company's management is responsible for the forecast.

As discussed under the caption "Income From Investee" in the summary of significant forecast assumptions, the forecast includes income from an equity investee constituting 23 percent of forecasted net income, which is management's estimate of the Company's share of the investee's income to be accrued for 20XX. The investee has not prepared a forecast for the year ending December 31, 20XX, and we were therefore unable to obtain suitable support for this assumption.

Because, as described in the preceding paragraph, we are unable to evaluate management's assumption regarding income from an equity investee and other assumptions that depend thereon, the scope of our work was not sufficient to express, and we do not express, an opinion with respect to the presentation of or the assumptions underlying the accompanying forecast. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

[*Signature*]

[*Date*]

.44 When there is a scope limitation and the practitioner also believes there are material departures from the presentation guidelines, those departures should be described in the practitioner's report.

Other Modifications to the Standard Examination Report

.45 The circumstances described below, although not necessarily resulting in modifications to the practitioner's opinion, would result in the following types of modifications to the standard examination report.

.46 *Emphasis of a Matter.* In some circumstances, the practitioner may wish to emphasize a matter regarding the prospective financial statements but nevertheless intends to express an unqualified opinion. The practitioner may present other information and comments he or she wishes to include, such as explanatory comments or other informative material, in a separate paragraph of his or her report.

.47 *Evaluation Based in Part on a Report of Another Practitioner.* When more than one practitioner is involved in the examination, the guidance provided for that situation in connection with examinations of historical financial statements is generally applicable. When the principal practitioner decides

to refer to the report of another practitioner as a basis, in part, for his or her own opinion, he or she should disclose that fact in stating the scope of the examination and should refer to the report of the other practitioner in expressing his or her opinion. Such a reference indicates the division of responsibility for the performance of the examination.

.48 *Comparative Historical Financial Information.* Prospective financial statements may be included in a document that also contains historical financial statements and a practitioner's report thereon.[23] In addition, the historical financial statements that appear in the document may be summarized and presented with the prospective financial statements for comparative purposes.[24] An example of the reference to the practitioner's report on the historical financial statements when he or she audited, reviewed, or compiled those statements is presented in paragraph .24.

.49 *Reporting When the Examination Is Part of a Larger Engagement.* When the practitioner's examination of prospective financial statements is part of a larger engagement, for example, a financial feasibility study or business acquisition study, it is appropriate to expand the report on the examination of the prospective financial statements to describe the entire engagement.

.50 The following is a report that might be issued when a practitioner chooses to expand his or her report on a financial feasibility study.[25]

Independent Accountant's Report

a. The Board of Directors
Example Hospital
Example, Texas

b. We have prepared a financial feasibility study of Example Hospital's (the Hospital's) plans to expand and renovate its facilities. The study was undertaken to evaluate the ability of the Hospital to meet its operating expenses, working capital needs, and other financial requirements, including the debt service requirements associated with the proposed $25,000,000 [*legal title of bonds*] issue, at an assumed average annual interest rate of 10.0 percent during the five years ending December 31, 20X6.

c. The proposed capital improvements program (the Program) consists of a new two-level addition, which is to provide fifty additional medical-surgical beds, increasing the complement to 275 beds. In addition, various administrative and support service areas in the present facilities are to be remodeled. The Hospital administration anticipates that construction is to begin June 30, 20X2, and to be completed by December 31, 20X3.

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[23] The practitioner's responsibility with respect to those historical financial statements upon which he or she is not engaged to perform a professional service is described in AU section 504, in the case of public entities, and SSARS No. 1, paragraph 3, in the case of nonpublic entities. [Footnote revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Standards for Accounting and Review Services No. 9.]

[24] AU section 552 discusses the practitioner's report for summarized financial statements derived from audited financial statements that are not included in the same document.

[25] Although the entity referred to in the report is a hospital, the form of report is also applicable to other entities such as hotels or stadiums. Also, although the illustrated report format and language should not be departed from in any significant way, the language used should be tailored to fit the circumstances that are unique to a particular engagement (for example, the description of the proposed capital improvement program, paragraph *c*; the proposed financing of the program, paragraphs *b* and *d*; the specific procedures applied by the practitioner, paragraph *e*; and any explanatory comments included in emphasis-of-a-matter paragraphs, paragraph *i*, which deals with general matter; and paragraph *j*, which deals with specific matters).

d. The estimated total cost of the Program is approximately $30,000,000. It is assumed that the $25,000,000 of revenue bonds that the Example Hospital Finance Authority proposes to issue would be the primary source of funds for the Program. The responsibility for payment of debt service on the bonds is solely that of the Hospital. Other necessary funds to finance the Program are assumed to be provided from the Hospital's funds, from a local fund drive, and from interest earned on funds held by the bond trustee during the construction period.

e. Our procedures included analysis of the following:

- Program history, objectives, timing, and financing
- The future demand for the Hospital's services, including consideration of the following:
  - — Economic and demographic characteristics of the Hospital's defined service area
  - — Locations, capacities, and competitive information pertaining to other existing and planned area hospitals
  - — Physician support for the Hospital and its programs
  - — Historical utilization levels
- Planning agency applications and approvals
- Construction and equipment costs, debt service requirements, and estimated financing costs
- Staffing patterns and other operating considerations
- Third-party reimbursement policy and history
- Revenue/expense/volume relationships

f. We also participated in gathering other information, assisted management in identifying and formulating its assumptions, and assembled the accompanying financial forecast based on those assumptions.

g. The accompanying financial forecast for the annual periods ending December 31, 20X2, through 20X6, is based on assumptions that were provided by or reviewed with and approved by management. The financial forecast includes the following:

- Balance sheets
- Statements of operations
- Statements of cash flows
- Statements of changes in net assets

h. We have examined the financial forecast. Example Hospital's management is responsible for the forecast. Our responsibility is to express an opinion on the forecast based on our examination. Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecast. We believe that our examination provides a reasonable basis for our opinion.

i. Legislation and regulations at all levels of government have affected and may continue to affect revenues and expenses of hospitals. The financial forecast is based on legislation and regulations currently in effect. If future legislation or regulations related to hospital operations

are enacted, such legislation or regulations could have a material effect on future operations.

j. The interest rate, principal payments, Program costs, and other financing assumptions are described in the section entitled "Summary of Significant Forecast Assumptions and Rationale." If actual interest rates, principal payments, and funding requirements are different from those assumed, the amount of the bond issue and debt service requirements would need to be adjusted accordingly from those indicated in the forecast. If such interest rates, principal payments, and funding requirements are lower than those assumed, such adjustments would not adversely affect the forecast.

k. Our conclusions are presented below.

- In our opinion, the accompanying financial forecast is presented in conformity with guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants.
- In our opinion, the underlying assumptions provide a reasonable basis for management's forecast. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material.
- The accompanying financial forecast indicates that sufficient funds could be generated to meet the Hospital's operating expenses, working capital needs, and other financial requirements, including the debt service requirements associated with the proposed $25,000,000 bond issue, during the forecast periods. However, the achievement of any financial forecast is dependent on future events, the occurrence of which cannot be assured.

l. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

[*Signature*]

[*Date*]

Applying Agreed-Upon Procedures to Prospective Financial Statements

.51 The practitioner who accepts an engagement to apply agreed-upon procedures to prospective financial statements should follow the general, fieldwork, and reporting standards for attest engagements set forth in section 101 and the guidance set forth herein and in section 201, *Agreed-Upon Procedures Engagements*.

.52 A practitioner may perform an agreed-upon procedures attest engagement on prospective financial statements[26] provided the following conditions are met.

a. The practitioner is independent.

b. The practitioner and the specified parties agree upon the procedures performed or to be performed by the practitioner.

[26] Practitioners should follow the guidance in AU section 634, *Letters for Underwriters and Certain Other Requesting Parties*, when requested to perform agreed-upon procedures on a forecast and report thereon in a letter for an underwriter.

c. The specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes.

d. The prospective financial statements include a summary of significant assumptions.

e. The prospective financial statements to which the procedures are to be applied are subject to reasonably consistent evaluation against criteria that are suitable and available to the specified parties.

f. Criteria to be used in the determination of findings are agreed upon between the practitioner and the specified parties.[27]

g. The procedures to be applied to the prospective financial statements are expected to result in reasonably consistent findings using the criteria.

h. Evidential matter related to the prospective financial statements to which the procedures are applied is expected to exist to provide a reasonable basis for expressing the findings in the practitioner's report.

i. Where applicable, the practitioner and the specified users agree on any agreed-upon materiality limits for reporting purposes. (See section 201.25.)

j. Use of the report is to be restricted to the specified parties.[28]

.53 Generally, the practitioner's procedures may be as limited or as extensive as the specified parties desire, as long as the specified parties take responsibility for their sufficiency. However, mere reading of prospective financial statements does not constitute a procedure sufficient to permit a practitioner to report on the results of applying agreed-upon procedures to such statements. (See section 201.15.)

.54 To satisfy the requirements that the practitioner and the specified parties agree upon the procedures performed or to be performed and that the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes, ordinarily the practitioner should communicate directly with and obtain affirmative acknowledgment from each of the specified parties. For example, this may be accomplished by meeting with the specified parties or by distributing a draft of the anticipated report or a copy of an engagement letter to the specified parties and obtaining their agreement. If the practitioner is not able to communicate directly with all of the specified parties, the practitioner may satisfy these requirements by applying any one or more of the following or similar procedures:

- Compare the procedures to be applied to written requirements of the specified parties.
- Discuss the procedures to be applied with appropriate representatives of the specified parties involved.
- Review relevant contracts with or correspondence from the specified parties.

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[27] For example, accounting principles and other presentation criteria as discussed in chapter 8, "Presentation Guidelines," of the AICPA Audit and Accounting Guide *Guide for Prospective Financial Information*.

[28] In some cases, restricted-use reports filed with regulatory agencies are required by law or regulation to be made available to the public as a matter of public record. Also, a regulatory agency as part of its oversight responsibility for an entity may require access to restricted-use reports in which they are not named as a specified party. (See section 101.79.)

The practitioner should not report on an engagement when specified parties do not agree upon the procedures performed or to be performed and do not take responsibility for the sufficiency of the procedures for their purposes. (See section 201.36 for guidance on satisfying these requirements when the practitioner is requested to add other parties as specified parties after the date of completion of the agreed-upon procedures.)

Reports on the Results of Applying Agreed-Upon Procedures

.55 The practitioner's report on the results of applying agreed-upon procedures should be in the form of procedures and findings. The practitioner's report should contain the following elements:

a. A title that includes the word *independent*

b. Identification of the specified parties

c. Reference to the prospective financial statements covered by the practitioner's report and the character of the engagement

d. A statement that the procedures performed were those agreed to by the specified parties identified in the report

e. Identification of the responsible party and a statement that the prospective financial statements are the responsibility of the responsible party

f. A statement that the agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants

g. A statement that the sufficiency of the procedures is solely the responsibility of the specified parties and a disclaimer of responsibility for the sufficiency of those procedures

h. A list of the procedures performed (or reference thereto) and related findings (The practitioner should not provide negative assurance—see section 201.24.)

i. Where applicable, a description of any agreed-upon materiality limits (See section 201.25.)

j. A statement that the practitioner was not engaged to and did not conduct an examination of prospective financial statements; a disclaimer of opinion on whether the presentation of the prospective financial statements is in conformity with AICPA presentation guidelines and on whether the underlying assumptions provide a reasonable basis for the forecast, or a reasonable basis for the projection given the hypothetical assumptions; and a statement that if the practitioner had performed additional procedures, other matters might have come to his or her attention that would have been reported

k. A statement of restrictions on the use of the report because it is intended to be used solely by the specified parties

l. Where applicable, reservations or restrictions concerning procedures or findings as discussed in section 201.33, .35, .39, and .40

m. A caveat that the prospective results may not be achieved

n. A statement that the practitioner assumes no responsibility to update the report for events and circumstances occurring after the date of the report

o. Where applicable, a description of the nature of the assistance provided by a specialist as discussed in section 201.19–.21

p. The manual or printed signature of the practitioner's firm

q. The date of the report

.56 The following illustrates a report on applying agreed-upon procedures to the prospective financial statements. (See section 201.)

Independent Accountant's Report on Applying Agreed-Upon Procedures

Board of Directors—XYZ Corporation

Board of Directors—ABC Company

At your request, we have performed certain agreed-upon procedures, as enumerated below, with respect to the forecasted balance sheet and the related forecasted statements of income, retained earnings, and cash flows of DEF Company, a subsidiary of ABC Company, as of December 31, 20XX, and for the year then ending. These procedures, which were agreed to by the Boards of Directors of XYZ Corporation and ABC Company, were performed solely to assist you in evaluating the forecast in connection with the proposed sale of DEF Company to XYZ Corporation. DEF Company's management is responsible for the forecast.

This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the specified parties. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

[*Include paragraphs to enumerate procedures and findings*.]

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on the accompanying prospective financial statements. Accordingly, we do not express an opinion on whether the prospective financial statements are presented in conformity with AICPA presentation guidelines or on whether the underlying assumptions provide a reasonable basis for the presentation. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

This report is intended solely for the information and use of the Boards of Directors of ABC Company and XYZ Corporation and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

Partial Presentations

.57 The practitioner's procedures on a partial presentation may be affected by the nature of the information presented. Many elements of prospective financial statements are interrelated. The practitioner should give appropriate consideration to whether key factors affecting elements, accounts, or items that are interrelated with those in the partial presentation he or she has been engaged to examine or compile have been considered, including key

factors that may not necessarily be obvious to the partial presentation (for example, productive capacity relative to a sales forecast), and whether all significant assumptions have been disclosed. The practitioner may find it necessary for the scope of the examination or compilation of some partial presentations to be similar to that for the examination or compilation of a presentation of prospective financial statements. For example, the scope of a practitioner's procedures when he or she examines forecasted results of operations would likely be similar to that of procedures used for the examination of prospective financial statements since the practitioner would most likely need to consider the interrelationships of all accounts in the examination of results of operations.

.58 Because partial presentations are generally appropriate only for limited use, reports on partial presentations of both forecasted and projected information should include a description of any limitations on the usefulness of the presentation.

Other Information

.59 When a practitioner's compilation, review, or audit report on historical financial statements is included in a practitioner-submitted document containing prospective financial statements, the practitioner should either examine, compile, or apply agreed-upon procedures to the prospective financial statements and report accordingly, unless the following occur.

a. The prospective financial statements are labeled as a "budget."

b. The budget does not extend beyond the end of the current fiscal year.

c. The budget is presented with interim historical financial statements for the current year.

In such circumstances, the practitioner need not examine, compile, or apply agreed-upon procedures to the budget; however, he or she should report on it and—

a. Indicate that he or she did not examine or compile the budget.

b. Disclaim an opinion or any other form of assurance on the budget.

In addition, the budgeted information may omit the summaries of significant assumptions and accounting policies required by the guidelines for presentation of prospective financial statements established by the AICPA, provided such omission is not, to the practitioner's knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such budgeted information, and is disclosed in the practitioner's report. The following is the form of the standard paragraphs to be added to the practitioner's report in this circumstance when the summaries of significant assumptions and accounting policies have been omitted.

> The accompanying budgeted balance sheet, statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 20XX, and for the six months then ending, have not been compiled or examined by us, and, accordingly, we do not express an opinion or any other form of assurance on them.
>
> Management has elected to omit the summaries of significant assumptions and accounting policies required under established guidelines for presentation of prospective financial statements. If the omitted summaries were included in the budgeted information, they might influence the user's conclusions about the company's budgeted information. Accordingly, this budgeted information is not designed for those who are not informed about such matters.

.60 When the practitioner's compilation, review, or audit report on historical financial statements is included in a client-prepared document containing prospective financial statements, the practitioner should not consent to the use of his or her name in the document unless:

a. He or she has examined, compiled, or applied agreed-upon procedures to the prospective financial statements and his or her report accompanies them.

b. The prospective financial statements are accompanied by an indication by the responsible party or the practitioner that the practitioner has not performed such a service on the prospective financial statements and that the practitioner assumes no responsibility for them.

c. Another practitioner has examined, compiled, or applied agreed-upon procedures to the prospective financial statements and his or her report is included in the document.

In addition, if the practitioner has audited the historical financial statements and they accompany prospective financial statements that he or she did not examine, compile, or apply agreed-upon procedures to in certain[29] client-prepared documents, he or she should refer to AU section 550, *Other Information in Documents Containing Audited Financial Statements*.

.61 The practitioner whose report on prospective financial statements is included in a client-prepared document containing historical financial statements should not consent to the use of his or her name in the document unless:

a. He or she has compiled, reviewed, or audited the historical financial statements and his or her report accompanies them.

b. The historical financial statements are accompanied by an indication by the responsible party or the practitioner that the practitioner has not performed such a service on the historical financial statements and that the practitioner assumes no responsibility for them.

c. Another practitioner has compiled, reviewed, or audited the historical financial statements and his or her report is included in the document.

.62 An entity may publish various documents that contain information other than historical financial statements in addition to the compiled or examined prospective financial statements and the practitioner's report thereon. The practitioner's responsibility with respect to information in such a document does not extend beyond the financial information identified in the report, and he or she has no obligation to perform any procedures to corroborate other information contained in the document. However, the practitioner should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with the information, or manner of its presentation, appearing in the prospective financial statements.

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[29] AU section 550 applies only to such prospective financial statements contained in (*a*) annual reports to holders of securities or beneficial interests, annual reports of organizations for charitable or philanthropic purposes distributed to the public, and annual reports filed with regulatory authorities under the Securities Exchange Act of 1934 or (*b*) other documents to which the auditor, at the client's request, devotes attention. AU section 550 does not apply when the historical financial statements and report appear in a registration statement filed under the Securities Act of 1933 [in which case, see AU section 711, *Filings Under Federal Securities Statutes*].

.63 If the practitioner examines prospective financial statements included in a document containing inconsistent information, he or she might not be able to conclude that there is adequate support for each significant assumption. The practitioner should consider whether the prospective financial statements, his or her report, or both require revision. Depending on the conclusion he or she reaches, the practitioner should consider other actions that may be appropriate, such as issuing an adverse opinion, disclaiming an opinion because of a scope limitation, withholding the use of his or her report in the document, or withdrawing from the engagement.

.64 If the practitioner compiles the prospective financial statements included in the document containing inconsistent information, he or she should attempt to obtain additional or revised information. If he or she does not receive such information, the practitioner should withhold the use of his or her report or withdraw from the compilation engagement.

.65 If, while reading the other information appearing in the document containing the examined or compiled prospective financial statements, as described in the preceding paragraphs, the practitioner becomes aware of information that he or she believes is a material misstatement of fact that is not an inconsistent statement, he or she should discuss the matter with the responsible party. In connection with this discussion, the practitioner should consider that he or she may not have the expertise to assess the validity of the statement made, that there may be no standards by which to assess its presentation, and that there may be valid differences of judgment or opinion. If the practitioner concludes that he or she has a valid basis for concern, he or she should propose that the responsible party consult with some other party whose advice might be useful, such as the entity's legal counsel.

.66 If, after discussing the matter as described in paragraph .65, the practitioner concludes that a material misstatement of fact remains, the action he or she takes will depend on his or her judgment in the particular circumstances. The practitioner should consider steps such as notifying the responsible party in writing of his or her views concerning the information and consulting his or her legal counsel about further appropriate action in the circumstances.

Effective Date

.67 This section is effective when the date of the practitioner's report is on or after June 1, 2001. Early application is permitted.

.68

Appendix A
Minimum Presentation Guidelines*

1. Prospective information presented in the format of historical financial statements facilitates comparisons with financial position, results of operations, and cash flows of prior periods, as well as those actually achieved for the prospective period. Accordingly, prospective financial statements preferably should be in the format of the historical financial statements that would be issued for the period(s) covered unless there is an agreement between the responsible party and potential users specifying another format. Prospective financial statements may take the form of complete basic financial statements[1] or may be limited to the following minimum items (where such items would be presented for historical financial statements for the period).[2]

a. Sales or gross revenues

b. Gross profit or cost of sales

c. Unusual or infrequently occurring items

d. Provision for income taxes

e. Discontinued operations or extraordinary items

f. Income from continuing operations

g. Net income

h. Basic and diluted earnings per share

i. Significant changes in financial position[3]

j. A description of what the responsible party intends the prospective financial statements to present, a statement that the assumptions are based on the responsible party's judgment at the time the prospective information was prepared, and a caveat that the prospective results may not be achieved

k. Summary of significant assumptions

l. Summary of significant accounting policies

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* *Note:* This Appendix describes the minimum items that constitute a presentation of a financial forecast or a financial projection, as specified in the AICPA Audit and Accounting Guide *Guide for Prospective Financial Information*. Complete presentation guidelines for entities that choose to issue prospective financial statements, together with illustrative presentations, are included in the Guide. The Guide also prescribes presentation guidelines for partial presentations.

[1] The details of each statement may be summarized or condensed so that only the major items in each are presented. The usual footnotes associated with historical financial statements need not be included as such. However, significant assumptions and accounting policies should be disclosed.

[2] Similar types of financial information should be presented for entities for which these terms do not describe operations. Further, similar items should be presented if a comprehensive basis of accounting other than GAAP is used to present the prospective financial statements. For example, if the cash basis were used, item a would be cash receipts.

[3] The responsible party should disclose significant cash flows and other significant changes in balance sheet accounts during the period. However, neither a balance sheet nor a statement of cash flows, as described in FASB Statement No. 95, *Statement of Cash Flows*, is required. Furthermore, none of the specific captions or disclosures required by FASB Statement No. 95 is required. Significant changes disclosed will depend on the circumstances; however, such disclosures will often include cash flows from operations. See the AICPA Audit and Accounting Guide *Guide for Prospective Financial Information*, Exhibits 9.07 and 9.11, for illustrations of alternate methods of presenting significant cash flows.

2. A presentation that omits one or more of the applicable minimum items *a* through *i* above is a partial presentation, which would not ordinarily be appropriate for general use. If an omitted applicable minimum item is derivable from the information presented, the presentation would not be deemed to be a partial presentation. A presentation that contains the applicable minimum items *a* through *i* above, but omits items *j* through *l* above, is subject to all of the provisions of this section applicable to complete presentations.

.69

Appendix B

Training and Proficiency, Planning, and Procedures Applicable to Compilations

Training and Proficiency

1. The practitioner should be familiar with the guidelines for the preparation and presentation of prospective financial statements. The guidelines are contained in the AICPA Audit and Accounting Guide *Guide for Prospective Financial Information*.

2. The practitioner should possess or obtain a level of knowledge of the industry and the accounting principles and practices of the industry in which the entity operates or will operate that will enable him or her to compile prospective financial statements that are in appropriate form for an entity operating in that industry.

Planning the Compilation Engagement

3. To compile the prospective financial statements of an existing entity, the practitioner should obtain a general knowledge of the nature of the entity's business transactions and the key factors upon which its future financial results appear to depend. He or she should also obtain an understanding of the accounting principles and practices of the entity to determine whether they are comparable to those used within the industry in which the entity operates.

4. To compile the prospective financial statements of a proposed entity, the practitioner should obtain knowledge of the proposed operations and the key factors upon which its future results appear to depend and that have affected the performance of entities in the same industry.

Compilation Procedures

5. In a compilation of prospective financial statements the practitioner should perform the following, where applicable.

a. Establish an understanding with the client regarding the services to be performed. The understanding should include the objectives of the engagement, the client's responsibilities, the practitioner's responsibilities, and limitations of the engagement. The practitioner should document the understanding in the working papers, preferably through a written communication with the client. If the practitioner believes an understanding with the client has not been established, he or she should decline to accept or perform the engagement.

b. Inquire about the accounting principles used in the preparation of the prospective financial statements.

(1) For existing entities, compare the accounting principles used to those used in the preparation of previous historical financial statements and inquire whether such principles are the same as those expected to be used in the historical financial statements covering the prospective period.

(2) For entities to be formed or entities formed that have not commenced operations, compare specialized industry accounting principles used, if any, to those typically used in the industry. Inquire whether the accounting principles used for the prospective financial statements are those that are expected to be used when or if the entity commences operations.

c. Ask how the responsible party identifies the key factors and develops its assumptions.

d. List, or obtain a list of the responsible party's significant assumptions providing the basis for the prospective financial statements and consider whether there are any obvious omissions in light of the key factors upon which the prospective results of the entity appear to depend.

e. Consider whether there appear to be any obvious internal inconsistencies in the assumptions.

f. Perform or test the mathematical accuracy of the computations that translate the assumptions into prospective financial statements.

g. Read the prospective financial statements, including the summary of significant assumptions, and consider whether—

(1) The statements, including the disclosures of assumptions and accounting policies, appear to be not presented in conformity with the AICPA presentation guidelines for prospective financial statements.[1]

(2) The statements, including the summary of significant assumptions, appear to be not obviously inappropriate in relation to the practitioner's knowledge of the entity and its industry and, for the following:

(a) Financial forecast, the expected conditions and course of action in the prospective period

(b) Financial projection, the purpose of the presentation

h. If a significant part of the prospective period has expired, inquire about the results of operations or significant portions of the operations (such as sales volume), and significant changes in financial position, and consider their effect in relation to the prospective financial statements. If historical financial statements have been prepared for the expired portion of the period, the practitioner should read such statements and consider those results in relation to the prospective financial statements.

i. Confirm his or her understanding of the statements (including assumptions) by obtaining written representations from the responsible party. Because the amounts reflected in the statements are not supported by historical books and records but rather by assumptions, the practitioner should obtain representations in which the responsible party indicates its responsibility for the assumptions. The representations should be signed by the responsible party at the highest level of authority who the practitioner believes is responsible for and knowledgeable, directly or through others, about matters covered by the representations.

[1] Presentation guidelines for entities that issue prospective financial statements are set forth and illustrated in the AICPA Audit and Accounting Guide *Guide for Prospective Financial Information*.

(1) For a *financial forecast*, the representations should include the responsible party's assertion that the financial forecast presents, to the best of its knowledge and belief, the expected financial position, results of operations, and cash flows for the forecast period and that the forecast reflects the responsible party's judgment, based on present circumstances, of the expected conditions and its expected course of action. The representations should also include a statement that the forecast is presented in conformity with guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants. The representations should also include a statement that the assumptions on which the forecast is based are reasonable. If the forecast contains a range, the representation should also include a statement that, to the best of the responsible party's knowledge and belief, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.

(2) For a *financial projection*, the representations should include the responsible party's assertion that the financial projection presents, to the best of its knowledge and belief, the expected financial position, results of operations, and cash flows for the projection period given the hypothetical assumptions, and that the projection reflects its judgment, based on present circumstances, of expected conditions and its expected course of action given the occurrence of the hypothetical events. The representations should also (*i*) identify the hypothetical assumptions and describe the limitations on the usefulness of the presentation, (*ii*) state that the assumptions are appropriate, (*iii*) indicate if the hypothetical assumptions are improbable, and (*iv*) if the projection contains a range, include a statement that, to the best of the responsible party's knowledge and belief, given the hypothetical assumptions, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner. The representations should also include a statement that the projection is presented in conformity with guidelines for presentation of a projection established by the American Institute of Certified Public Accountants.

j. Consider, after applying the above procedures, whether he or she has received representations or other information that appears to be obviously inappropriate, incomplete, or otherwise misleading and, if so, attempt to obtain additional or revised information. If he or she does not receive such information, the practitioner should ordinarily withdraw from the compilation engagement.[2] (Note that the omission of disclosures, other than those relating to significant assumptions, would not require the practitioner to withdraw; see paragraph .26.)

[2] The practitioner need not withdraw from the engagement if the effect of such information on the prospective financial statements does not appear to be material.

.70

Appendix C

Training and Proficiency, Planning, and Procedures Applicable to Examinations

Training and Proficiency

1. The practitioner should be familiar with the guidelines for the preparation and presentation of prospective financial statements. The guidelines are contained in the AICPA Audit and Accounting Guide *Guide for Prospective Financial Information*.

2. The practitioner should possess or obtain a level of knowledge of the industry and the accounting principles and practices of the industry in which the entity operates or will operate that will enable him or her to examine prospective financial statements that are in appropriate form for an entity operating in that industry.

Planning an Examination Engagement

3. Planning the examination engagement involves developing an overall strategy for the expected scope and conduct of the engagement. To develop such a strategy, the practitioner needs to have sufficient knowledge to enable him or her to adequately understand the events, transactions, and practices that, in his or her judgment, may have a significant effect on the prospective financial statements.

4. Factors to be considered by the practitioner in planning the examination include the following:

a. The accounting principles to be used and the type of presentation

b. The anticipated level of attestation risk related to the prospective financial statements[1]

c. Preliminary judgments about materiality levels

d. Items within the prospective financial statements that are likely to require revision or adjustment

e. Conditions that may require extension or modification of the practitioner's examination procedures

f. Knowledge of the entity's business and its industry

g. The responsible party's experience in preparing prospective financial statements

h. The length of the period covered by the prospective financial statements

i. The process by which the responsible party develops its prospective financial statements

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[1] *Attestation* risk is the risk that the practitioner may unknowingly fail to appropriately modify his or her examination report on prospective financial statements that are materially misstated, that is, that are not presented in conformity with AICPA presentation guidelines or have assumptions that do not provide a reasonable basis for management's forecast, or management's projection given the hypothetical assumptions. It consists of (*a*) the risk (consisting of *inherent risk* and *control risk*) that the prospective financial statements contain errors that could be material and (*b*) the risk (*detection risk*) that the practitioner will not detect such errors.

5. The practitioner should obtain knowledge of the entity's business, accounting principles, and the key factors upon which its future financial results appear to depend. The practitioner should focus on areas such as the following:

a. The availability and cost of resources needed to operate (Principal items usually include raw materials, labor, short-term and long-term financing, and plant and equipment.)

b. The nature and condition of markets in which the entity sells its goods or services, including final consumer markets if the entity sells to intermediate markets

c. Factors specific to the industry, including competitive conditions, sensitivity to economic conditions, accounting policies, specific regulatory requirements, and technology

d. Patterns of past performance for the entity or comparable entities, including trends in revenue and costs, turnover of assets, uses and capacities of physical facilities, and management policies

Examination Procedures

6. The practitioner should establish an understanding with the responsible party regarding the services to be performed. The understanding should include the objectives of the engagement, the responsible party's responsibilities, the practitioner's responsibilities, and limitations of the engagement. The practitioner should document the understanding in the working papers, preferably through a written communication with the responsible party. If the practitioner believes an understanding with the responsible party has not been established, he or she should decline to accept or perform the engagement. If the responsible party is different than the client, the practitioner should establish the understanding with both the client and the responsible party, and the understanding also should include the client's responsibilities.

7. The practitioner's objective in an examination of prospective financial statements is to accumulate sufficient evidence to restrict attestation risk to a level that is, in his or her professional judgment, appropriate for the level of assurance that may be imparted by his or her examination report. In a report on an examination of prospective financial statements, the practitioner provides assurance only about whether the prospective financial statements are presented in conformity with AICPA presentation guidelines and whether the assumptions provide a reasonable basis for management's forecast, or a reasonable basis for management's projection given the hypothetical assumptions. He or she does not provide assurance about the achievability of the prospective results because events and circumstances frequently do not occur as expected and achievement of the prospective results is dependent on the actions, plans, and assumptions of the responsible party.

8. In his or her examination of prospective financial statements, the practitioner should select from all available procedures—that is, procedures that assess inherent and control risk and restrict detection risk—any combination that can restrict attestation risk to such an appropriate level. The extent to which examination procedures will be performed should be based on the practitioner's consideration of the following:

a. The nature and materiality of the information to the prospective financial statements taken as a whole

b. The likelihood of misstatements

c. Knowledge obtained during current and previous engagements

d. The responsible party's competence with respect to prospective financial statements

e. The extent to which the prospective financial statements are affected by the responsible party's judgment, for example, its judgment in selecting the assumptions used to prepare the prospective financial statements

f. The adequacy of the responsible party's underlying data

9. The practitioner should perform those procedures he or she considers necessary in the circumstances to report on whether the assumptions provide a reasonable basis for the following.

a. *Financial forecast.* The practitioner can form an opinion that the assumptions provide a reasonable basis for the forecast if the responsible party represents that the presentation reflects, to the best of its knowledge and belief, its estimate of expected financial position, results of operations, and cash flows for the prospective period[2] and the practitioner concludes, based on his or her examination, (*i*) that the responsible party has explicitly identified all factors expected to materially affect the operations of the entity during the prospective period and has developed appropriate assumptions with respect to such factors[3] and (*ii*) that the assumptions are suitably supported.

b. *Financial projection given the hypothetical assumptions.* The practitioner can form an opinion that the assumptions provide a reasonable basis for the financial projection given the hypothetical assumptions if the responsible party represents that the presentation reflects, to the best of its knowledge and belief, expected financial position, results of operations, and cash flows for the prospective period given the hypothetical assumptions[4] and the practitioner concludes, based on his or her examination, that:

(1) The responsible party has explicitly identified all factors that would materially affect the operations of the entity during the prospective period if the hypothetical assumptions were to materialize and has developed appropriate assumptions with respect to such factors and

(2) The other assumptions are suitably supported given the hypothetical assumptions. However, as the number and significance of the hypothetical assumptions increase, the practitioner may not be able to satisfy himself or herself about the presentation as a whole by obtaining support for the remaining assumptions.

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[2] If the forecast contains a range, the representation should also include a statement that, to the best of the responsible party's knowledge and belief, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.

[3] An attempt to list all assumptions is inherently not feasible. Frequently, basic assumptions that have enormous potential impact are considered to be implicit, such as conditions of peace and absence of natural disasters.

[4] If the projection contains a range, the representation should also include a statement that, to the best of the responsible party's knowledge and belief, given the hypothetical assumptions, the item or items subject to the assumption are expected to actually fall within the range and that the range was not selected in a biased or misleading manner.

10. The practitioner should evaluate the support for the assumptions.

a. *Financial forecast*—The practitioner can conclude that assumptions are suitably supported if the preponderance of information supports each significant assumption.

b. *Financial projection*—In evaluating support for assumptions other than hypothetical assumptions, the practitioner can conclude that they are suitably supported if the preponderance of information supports each significant assumption given the hypothetical assumptions. The practitioner need not obtain support for the hypothetical assumptions, although he or she should consider whether they are consistent with the purpose of the presentation.

11. In evaluating the support for assumptions, the practitioner should consider—

a. Whether sufficient pertinent sources of information about the assumptions have been considered. Examples of external sources the practitioner might consider are government publications, industry publications, economic forecasts, existing or proposed legislation, and reports of changing technology. Examples of internal sources are budgets, labor agreements, patents, royalty agreements and records, sales backlog records, debt agreements, and actions of the board of directors involving entity plans.

b. Whether the assumptions are consistent with the sources from which they are derived.

c. Whether the assumptions are consistent with each other.

d. Whether the historical financial information and other data used in developing the assumptions are sufficiently reliable for that purpose. Reliability can be assessed by inquiry and analytical or other procedures, some of which may have been completed in past audits or reviews of the historical financial statements. If historical financial statements have been prepared for an expired part of the prospective period, the practitioner should consider the historical data in relation to the prospective results for the same period, where applicable. If the prospective financial statements incorporate such historical financial results and that period is significant to the presentation, the practitioner should make a review of the historical information in conformity with the applicable standards for a review.[5]

e. Whether the historical financial information and other data used in developing the assumptions are comparable over the periods specified or whether the effects of any lack of comparability were considered in developing the assumptions.

f. Whether the logical arguments or theory, considered with the data supporting the assumptions, are reasonable.

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[5] If the entity is an SEC registrant or non-SEC registrant that makes a filing with a regulatory agency in preparation for a public offering or listing, the practitioner should perform the procedures in AU section 722, *Interim Financial Information*, paragraphs .13 through .19. If the entity is nonpublic, the practitioner should perform the procedures in SSARS No. 1, *Compilation and Review of Financial Statements*, paragraphs 24 through 33. [Footnote revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 100 and Statement on Standards for Accounting and Review Services No. 9.]

12. In evaluating the preparation and presentation of the prospective financial statements, the practitioner should perform procedures that will provide reasonable assurance as to the following.

a. The presentation reflects the identified assumptions.

b. The computations made to translate the assumptions into prospective amounts are mathematically accurate.

c. The assumptions are internally consistent.

d. Accounting principles used in the—

(1) Financial forecast are consistent with the accounting principles expected to be used in the historical financial statements covering the prospective period and those used in the most recent historical financial statements, if any.

(2) Financial projection are consistent with the accounting principles expected to be used in the prospective period and those used in the most recent historical financial statements, if any, or that they are consistent with the purpose of the presentation.[6]

e. The presentation of the prospective financial statements follows the AICPA guidelines applicable for such statements.[7]

f. The assumptions have been adequately disclosed based on AICPA presentation guidelines for prospective financial statements.

13. The practitioner should consider whether the prospective financial statements, including related disclosures, should be revised because of any of the following:

a. Mathematical errors

b. Unreasonable or internally inconsistent assumptions

c. Inappropriate or incomplete presentation

d. Inadequate disclosure

14. The practitioner should obtain written representations from the responsible party acknowledging its responsibility for both the presentation and the underlying assumptions. The representations should be signed by the responsible party at the highest level of authority who the practitioner believes is responsible for and knowledgeable, directly or through others in the organization, about the matters covered by the representations. Paragraph .69, subparagraph 5*i* describes the specific representations to be obtained for a financial forecast and a financial projection. See paragraph .43 for guidance on the form of report to be rendered if the practitioner is not able to obtain the required representations.

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[6] The accounting principles used in a financial projection need not be those expected to be used in the historical financial statements for the prospective period if use of different principles is consistent with the purpose of the presentation.

[7] Presentation guidelines for entities that issue prospective financial statements are set forth and illustrated in the AICPA Audit and Accounting Guide *Guide for Prospective Financial Information*.

AT Section 401

Reporting on Pro Forma Financial Information

Source: SSAE No. 10.

Effective when the presentation of pro forma financial information is as of or for a period ending on or after June 1, 2001. Earlier application is permitted.

Introduction

.01 This section provides guidance to a practitioner who is engaged to issue or does issue an examination or a review report on pro forma financial information. Such an engagement should comply with the general and fieldwork standards set forth in section 101, *Attest Engagements*, and the specific performance and reporting standards set forth in this section.[1]

.02 When pro forma financial information is presented outside the basic financial statements but within the same document, and the practitioner is not engaged to report on the pro forma financial information, the practitioner's responsibilities are described in AU section 550, *Other Information in Documents Containing Audited Financial Statements*, and AU section 711, *Filings Under Federal Securities Statutes*.

.03 This section does not apply in those circumstances when, for purposes of a more meaningful presentation, a transaction consummated after the balance-sheet date is reflected in the historical financial statements (such as a revision of debt maturities or a revision of earnings per share calculations for a stock split).[2]

Presentation of Pro Forma Financial Information

.04 The objective of pro forma financial information is to show what the significant effects on historical financial information might have been had a consummated or proposed transaction (or event) occurred at an earlier date. Pro forma financial information is commonly used to show the effects of transactions such as the following:

- Business combination
- Change in capitalization

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[1] AU section 634, *Letters for Underwriters and Certain Other Requesting Parties*, paragraphs .03 through .05, identify certain parties who may request a letter. When one of those parties requests a letter or asks the practitioner to perform agreed-upon procedures on pro forma financial information in connection with an offering, the practitioner should follow the guidance in AU section 634.03, .10, .36, .42, and .43.

[2] In certain circumstances, generally accepted accounting principles (GAAP) may require the presentation of pro forma financial information in the financial statements or the accompanying notes. That information includes, for example, pro forma financial information required by Accounting Principles Board (APB) Opinion No. 16, *Business Combinations* (paragraphs 61, 65, and 96 [AC section B50.120, .124, and .165]); APB Opinion 20, *Accounting Changes* (paragraph 21 [AC section A06.117]); or, in some cases, pro forma financial information relating to subsequent events; see AU section 560, *Subsequent Events*, paragraph .05. For guidance in reporting on audited financial statements that include pro forma financial information for a business combination or subsequent event, see AU section 508, *Reports on Audited Financial Statements*, paragraph .28.

- Disposition of a significant portion of the business
- Change in the form of business organization or status as an autonomous entity
- Proposed sale of securities and the application of the proceeds

.05 This objective is achieved primarily by applying pro forma adjustments to historical financial information. Pro forma adjustments should be based on management's assumptions and give effect to all significant effects directly attributable to the transaction (or event).

.06 Pro forma financial information should be labeled as such to distinguish it from historical financial information. This presentation should describe the transaction (or event) that is reflected in the pro forma financial information, the source of the historical financial information on which it is based, the significant assumptions used in developing the pro forma adjustments, and any significant uncertainties about those assumptions. The presentation also should indicate that the pro forma financial information should be read in conjunction with related historical financial information and that the pro forma financial information is not necessarily indicative of the results (such as financial position and results of operations, as applicable) that would have been attained had the transaction (or event) actually taken place earlier.[3]

Conditions for Reporting

.07 The practitioner may agree to report on an examination or a review of pro forma financial information if the following conditions are met.

a. The document that contains the pro forma financial information includes (or incorporates by reference) complete historical financial statements of the entity for the most recent year (or for the preceding year if financial statements for the most recent year are not yet available) and, if pro forma financial information is presented for an interim period, the document also includes (or incorporates by reference) historical interim financial information for that period (which may be presented in condensed form).[4] In the case of a business combination, the document should include (or incorporate by reference) the appropriate historical financial information for the significant constituent parts of the combined entity.

b. The historical financial statements of the entity (or, in the case of a business combination, of each significant constituent part of the combined entity) on which the pro forma financial information is based have been audited or reviewed.[5] The practitioner's attestation risk relating to the pro forma financial information is

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[3] For further guidance on the presentation of pro forma financial information included in filings with the Securities and Exchange Commission (SEC), see Article 11 of Regulation S-X.

[4] For pro forma financial information included in an SEC Form 8-K, historical financial information previously included in an SEC filing would meet this requirement. Interim historical financial information may be presented as a column in the pro forma financial information.

[5] The practitioner's audit or review report should be included (or incorporated by reference) in the document containing the pro forma financial information. The review may be that as defined in AU section 722, *Interim Financial Information*, for SEC registrants or non-SEC registrants that make a filing with a regulatory agency in preparation for a public offering or listing, or as defined in Statement on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements*, for nonpublic companies. [Footnote revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 100.]

affected by the scope of the engagement providing the practitioner with assurance about the underlying historical financial information to which the pro forma adjustments are applied. Therefore, the level of assurance given by the practitioner on the pro forma financial information, as of a particular date or for a particular period, should be limited to the level of assurance provided on the historical financial statements (or, in the case of a business combination, the lowest level of assurance provided on the underlying historical financial statements of any significant constituent part of the combined entity). For example, if the underlying historical financial statements of each constituent part of the combined entity have been audited at year-end and reviewed at an interim date, the practitioner may perform an examination or a review of the pro forma financial information at year-end but is limited to performing a review of the pro forma financial information at the interim date.

c. The practitioner who is reporting on the pro forma financial information should have an appropriate level of knowledge of the accounting and financial reporting practices of each significant constituent part of the combined entity. This would ordinarily have been obtained by the practitioner auditing or reviewing historical financial statements of each entity for the most recent annual or interim period for which the pro forma financial information is presented. If another practitioner has performed such an audit or a review, the need, by a practitioner reporting on the pro forma financial information, for an understanding of the entity's accounting and financial reporting practices is not diminished, and that practitioner should consider whether, under the particular circumstances, he or she can acquire sufficient knowledge of these matters to perform the procedures necessary to report on the pro forma financial information.

Practitioner's Objective

.08 The objective of the practitioner's examination procedures applied to pro forma financial information is to provide reasonable assurance as to whether—

- Management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the underlying transaction (or event).
- The related pro forma adjustments give appropriate effect to those assumptions.
- The pro forma column reflects the proper application of those adjustments to the historical financial statements.

.09 The objective of the practitioner's review procedures applied to pro forma financial information is to provide negative assurance as to whether any information came to the practitioner's attention to cause him or her to believe that—

- Management's assumptions do not provide a reasonable basis for presenting the significant effects directly attributable to the underlying transaction (or event).
- The related pro forma adjustments do not give appropriate effect to those assumptions.

- The pro forma column does not reflect the proper application of those adjustments to the historical financial statements.

Procedures

.10 Other than the procedures applied to the historical financial statements,[6] the procedures the practitioner should apply to the assumptions and pro forma adjustments for either an examination or a review engagement are as follows.

a. Obtain an understanding of the underlying transaction (or event), for example, by reading relevant contracts and minutes of meetings of the board of directors and by making inquiries of appropriate officials of the entity, and, in cases, of the entity acquired or to be acquired.

b. Obtain a level of knowledge of each constituent part of the combined entity in a business combination that will enable the practitioner to perform the required procedures. Procedures to obtain this knowledge may include communicating with other practitioners who have audited or reviewed the historical financial information on which the pro forma financial information is based. Matters that may be considered include accounting principles and financial reporting practices followed, transactions between the entities, and material contingencies.

c. Discuss with management their assumptions regarding the effects of the transaction (or event).

d. Evaluate whether pro forma adjustments are included for all significant effects directly attributable to the transaction (or event).

e. Obtain sufficient evidence in support of such adjustments. The evidence required to support the level of assurance given is a matter of professional judgment. The practitioner typically would obtain more evidence in an examination engagement than in a review engagement. Examples of evidence that the practitioner might consider obtaining are purchase, merger or exchange agreements, appraisal reports, debt agreements, employment agreements, actions of the board of directors, and existing or proposed legislation or regulatory actions.

f. Evaluate whether management's assumptions that underlie the pro forma adjustments are presented in a sufficiently clear and comprehensive manner. Also, evaluate whether the pro forma adjustments are consistent with each other and with the data used to develop them.

g. Determine that computations of pro forma adjustments are mathematically correct and that the pro forma column reflects the proper application of those adjustments to the historical financial statements.

h. Obtain written representations from management concerning their—

- Responsibility for the assumptions used in determining the pro forma adjustments

[6] See paragraph .07*b*.

- Assertion that the assumptions provide a reasonable basis for presenting all of the significant effects directly attributable to the transaction (or event), that the related pro forma adjustments give appropriate effect to those assumptions, and that the pro forma column reflects the proper application of those adjustments to the historical financial statements
- Assertion that the significant effects directly attributable to the transaction (or event) are appropriately disclosed in the pro forma financial information

i. Read the pro forma financial information and evaluate whether—

- The underlying transaction (or event), the pro forma adjustments, the significant assumptions and the significant uncertainties, if any, about those assumptions have been appropriately described.
- The source of the historical financial information on which the pro forma financial information is based has been appropriately identified.

Reporting on Pro Forma Financial Information

.11 The practitioner's report on pro forma financial information should be dated as of the completion of the appropriate procedures. The practitioner's report on pro forma financial information may be added to the practitioner's report on historical financial information, or it may appear separately. If the reports are combined and the date of completion of the procedures for the examination or review of the pro forma financial information is after the date of completion of the fieldwork for the audit or review of the historical financial information, the combined report should be dual-dated. (For example, "February 15, 20X2, except for the paragraphs regarding pro forma financial information as to which the date is March 20, 20X2.")

.12 A practitioner's examination report on pro forma financial information should include the following:

a. A title that includes the word *independent*

b. An identification of the pro forma financial information

c. A reference to the financial statements from which the historical financial information is derived and a statement that such financial statements were audited (The report on pro forma financial information should refer to any modification in the practitioner's report on the historical financial information.)

d. An identification of the responsible party and a statement that the responsible party is responsible for the pro forma financial information

e. A statement that the practitioner's responsibility is to express an opinion on the pro forma financial information based on his or her examination

f. A statement that the examination of the pro forma financial information was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as the practitioner considered necessary in the circumstances

g. A statement that the practitioner believes that the examination provides a reasonable basis for his or her opinion

h. A separate paragraph explaining the objective of pro forma financial information and its limitations

i. The practitioner's opinion as to whether management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the transaction (or event), whether the related pro forma adjustments give appropriate effect to those assumptions, and whether the pro forma column reflects the proper application of those adjustments to the historical financial statements (see paragraphs .18 and .20)

j. The manual or printed signature of the practitioner's firm

k. The date of the examination report

.13 A practitioner's review report on pro forma financial information should include the following:

a. A title that includes the word *independent*

b. An identification of the pro forma financial information

c. A reference to the financial statements from which the historical financial information is derived and a statement as to whether such financial statements were audited or reviewed (The report on pro forma financial information should refer to any modification in the practitioner's report on the historical financial information.)

d. An identification of the responsible party and a statement that the responsible party is responsible for the pro forma financial information

e. A statement that the review of the pro forma financial information was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants

f. A statement that a review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the pro forma financial information and, accordingly, the practitioner does not express such an opinion

g. A separate paragraph explaining the objective of pro forma financial information and its limitations

h. The practitioner's conclusion as to whether any information came to the practitioner's attention to cause him or her to believe that management's assumptions do not provide a reasonable basis for presenting the significant effects directly attributable to the transaction (or event), or that the related pro forma adjustments do not give appropriate effect to those assumptions, or that the pro forma column does not reflect the proper application of those adjustments to the historical financial statements (See paragraphs .19 and .20.)

i. The manual or printed signature of the practitioner's firm

j. The date of the review report

.14 Nothing precludes the practitioner from restricting the use of the report (see section 101.78–.83).

.15 Because a pooling-of-interests business combination is accounted for by combining historical amounts retroactively, pro forma adjustments for a proposed transaction generally affect only the equity section of the pro forma

condensed balance sheet. Further, because of the requirements of the Accounting Principles Board Opinion (APB) No. 16, *Business Combinations* [AC Section B50], a business combination effected as a pooling of interests would not ordinarily involve a choice of assumptions by management. Accordingly, a report on a proposed pooling transaction need not address management's assumptions unless the pro forma financial information includes adjustments to conform the accounting principles of the combining entities. (See paragraph .21.)

.16 Restrictions on the scope of the engagement (see section 101.73–.75), reservations about the propriety of the assumptions and the conformity of the presentation with those assumptions (including adequate disclosure of significant matters), or other reservations may require the practitioner to qualify the opinion, disclaim an opinion, or withdraw from the engagement.[7] The practitioner should disclose all substantive reasons for any report modifications. Uncertainty as to whether the transaction (or event) will be consummated would not ordinarily require a report modification. (See paragraph .22.)

Effective Date

.17 This section is effective when the presentation of pro forma financial information is as of or for a period ending on or after June 1, 2001. Early application is permitted.

[7] See section 101.76 and .77.

.18

Appendix A

Report on Examination of Pro Forma Financial Information

Independent Accountant's Report

We have examined the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*][8] the accompanying pro forma financial condensed balance sheet of X Company as of December 31, 20X1, and the pro forma condensed statement of income for the year then ended. The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were audited by other accountants,[9] appearing elsewhere herein [*or incorporated by reference*].[10] Such pro forma adjustments are based upon management's assumptions described in Note 2. X Company's management is responsible for the pro forma financial information. Our responsibility is to express an opinion on the pro forma financial information based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the transaction [*or event*] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [*or event*] actually occurred earlier.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the subject matter.*]

In our opinion, management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma column reflects the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 20X1, and the pro forma condensed statement of income for the year then ended.

[*Signature*]

[*Date*]

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[8] This wording is appropriate when one column of pro forma financial information is presented without separate columns of historical financial information and pro forma adjustments.

[9] If either accountant's report includes an explanatory paragraph or is other than unqualified, that fact should be referred to within this report.

[10] If the option in footnote 4 to paragraph .07*a* is followed, the report should be appropriately modified.

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Appendix B

Report on Review of Pro Forma Financial Information

Independent Accountant's Report

We have reviewed the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*][11] the accompanying pro forma condensed balance sheet of X Company as of March 31, 20X2, and the pro forma condensed statement of income for the three months then ended. These historical condensed financial statements are derived from the historical unaudited financial statements of X Company, which were reviewed by us, and of Y Company, which were reviewed by other accountants,[12,13] appearing elsewhere herein [*or incorporated by reference*].[14] Such pro forma adjustments are based on management's assumptions as described in Note 2. X Company's management is responsible for the pro forma financial information.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assumptions, the pro forma adjustments and the application of those adjustments to historical financial information. Accordingly, we do not express such an opinion.

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the transaction [*or event*] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [*or event*] actually occurred earlier.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the subject matter.*]

Based on our review, nothing came to our attention that caused us to believe that management's assumptions do not provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, that the related pro forma adjustments do not give appropriate effect to those assumptions, or that the pro forma column does not reflect the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of March 31, 20X2, and the pro forma condensed statement of income for the three months then ended.

[*Signature*]

[*Date*]

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[11] This wording is appropriate when one column of pro forma financial information is presented without separate columns of historical financial information and pro forma adjustments.

[12] If either accountant's report includes an explanatory paragraph or is modified, that fact should be referred to within this report.

[13] Where one set of historical financial statements is audited and the other set is reviewed, wording similar to the following would be appropriate:

> The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were reviewed by other accountants, appearing elsewhere herein [*or incorporated by reference*].

[14] If the option in footnote 4 to paragraph .07*a* is followed, the report should be appropriately modified.

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Appendix C
Report on Examination of Pro Forma Financial Information at Year-End With a Review of Pro Forma Financial Information for a Subsequent Interim Date

Independent Accountant's Report

We have examined the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*][15] the accompanying pro forma financial condensed balance sheet of X Company as of December 31, 20X1, and the pro forma condensed statement of income for the year then ended. The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were audited by other accountants,[16] appearing elsewhere herein [*or incorporated by reference*].[17] Such pro forma adjustments are based upon management's assumptions described in Note 2. X Company's management is responsible for the pro forma financial information. Our responsibility is to express an opinion on the pro forma financial information based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In addition, we have reviewed the pro forma adjustments and the application of those adjustments to the historical amounts in [*the assembly of*][15] the accompanying pro forma condensed balance sheet of X Company as of March 31, 20X2, and the pro forma condensed statement of income for the three months then ended. The historical condensed financial statements are derived from the historical financial statements of X Company, which were reviewed by us, and of Y Company, which were reviewed by other accountants,[18] appearing elsewhere herein [*or incorporated by reference*].[19] Such pro forma adjustments are based upon management's assumptions as described in Note 2. Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on

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[15] This wording is appropriate when one column of pro forma financial information is presented without separate columns of historical financial information and pro forma adjustments.

[16] If either accountant's report includes an explanatory paragraph or is other than unqualified, that fact should be referred to within this report.

[17] If the option in footnote 4 to paragraph .07*a* is followed, the report should be appropriately modified.

[15] This wording is appropriate when one column of pro forma financial information is presented without separate columns of historical financial information and pro forma adjustments.

[18] Where one set of historical financial statements is audited and the other set is reviewed, wording similar to the following would be appropriate:

> The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were reviewed by other accountants, appearing elsewhere herein [*or incorporated by reference*].

[19] If the option in footnote 4 to paragraph .07*a* is followed, the report should be appropriately modified.

management's assumptions, the pro forma adjustments, and the application of those adjustments to historical financial information. Accordingly, we do not express such an opinion on the pro forma adjustments or the application of such adjustments to the pro forma condensed balance sheet as of March 31, 20X2, and the pro forma condensed statement of income for the three months then ended.

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the transactions [*or event*] occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction [*or event*] actually occurred earlier.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagements or the subject matter.*]

In our opinion, management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma column reflects the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 20X1, and the pro forma condensed statement of income for the year then ended.

Based on our review, nothing came to our attention that caused us to believe that management's assumptions do not provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, that the related pro forma adjustments do not give appropriate effect to those assumptions, or that the pro forma column does not reflect the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of March 31, 20X2, and the pro forma condensed statement of income for the three months then ended.

[*Signature*]

[*Date*]

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Appendix D

Report on Examination of Pro Forma Financial Information Giving Effect to a Business Combination to Be Accounted for as a Pooling of Interests[20]

Independent Accountant's Report

We have examined the pro forma adjustments reflecting the proposed business combination to be accounted for as a pooling of interests described in Note 1 and the application of those adjustments to the historical amounts in the accompanying pro forma condensed balance sheet of X Company as of December 31, 20X1, and the pro forma condensed statements of income for each of three years in the period then ended. These historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us,[21] and of Y Company, which were audited by other accountants, appearing elsewhere herein [*or incorporated by reference*].[22] Such pro forma adjustments are based upon management's assumptions described in Note 2. X Company's management is responsible for the pro forma financial information. Our responsibility is to express an opinion on the pro forma financial information based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the transactions [*or event*] occurred at an earlier date.

[*Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the subject matter.*]

In our opinion, the accompanying condensed pro forma financial statements of X Company as of December 31, 20X1, and for each of the three years in the period then ended give appropriate effect to the pro forma adjustments necessary to reflect the proposed business combination on a pooling of interests basis as described in Note 1 and the pro forma column reflects the proper application of those adjustments to the historical financial statements.

[*Signature*]

[*Date*]

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[20] See paragraph .15 for a discussion of the form of the opinion on pro forma financial information in a pooling of interests business combination.

[21] If either accountant's report includes an explanatory paragraph or is other than unqualified, that fact should be referred to within this report.

[22] If the option in footnote 4 to paragraph .07*a* is followed, the report should be appropriately modified.

.22

Appendix E

Other Example Reports

An example of a report qualified because of a scope limitation follows.

Independent Accountant's Report

We have examined the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*][23] the accompanying pro forma condensed balance sheet of X Company as of December 31, 20X1, and the pro forma condensed statement of income for the year then ended. The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were audited by other accountants,[24] appearing elsewhere herein [*or incorporated by reference*].[25] Such pro forma adjustments are based upon management's assumptions described in Note 2. X Company's management is responsible for the pro forma financial information. Our responsibility is to express an opinion on the pro forma financial information based on our examination.

Except as described below, our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

We are unable to perform the examination procedures we considered necessary with respect to assumptions relating to the proposed loan described in Adjustment E in Note 2.

[*Same paragraph as third paragraph in examination report in paragraph .18*]

In our opinion, except for the effects of such changes, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to the assumptions relating to the proposed loan, management's assumptions provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma column reflects the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 20X1, and the pro forma condensed statement of income for the year then ended.

[*Signature*]

[*Date*]

An example of a report qualified for reservations about the propriety of assumptions on an acquisition transaction follows:

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[23] This wording is appropriate when one column of pro forma financial information is presented without separate columns of historical financial information and pro forma adjustments.

[24] If either accountant's report includes an explanatory paragraph or is other than unqualified, that fact should be referred to within this report.

[25] If the option in footnote 4 to paragraph .07*a* is followed, the report should be appropriately modified.

[*Same first three paragraphs as examination report in paragraph .18*]

As discussed in Note 2 to the pro forma financial statements, the pro forma adjustments reflect management's assumption that X Division of the acquired company will be sold. The net assets of this division are reflected at their historical carrying amount; generally accepted accounting principles require these net assets to be recorded at estimated net realizable value.

In our opinion, except for inappropriate valuation of the net assets of X Division, management's assumptions described in Note 2 provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction [*or event*] described in Note 1, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma column reflects the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet as of December 31, 20X1, and the pro forma condensed statement of income for the year then ended.

[*Signature*]

[*Date*]

An example of a disclaimer of opinion because of a scope limitation follows:

Independent Accountant's Report

We were engaged to examine the pro forma adjustments reflecting the transaction [*or event*] described in Note 1 and the application of those adjustments to the historical amounts in [*the assembly of*][26] the accompanying pro forma financial condensed balance sheet of X Company as of December 31, 20X1, and the pro forma condensed statement of income for the year then ended. The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were audited by other accountants,[27] appearing elsewhere herein [*or incorporated by reference*].[28] Such pro forma adjustments are based upon management's assumptions described in Note 2. X Company's management is responsible for the pro forma financial information.

As discussed in Note 2 to the pro forma financial statements, the pro forma adjustments reflect management's assumptions that the elimination of duplicate facilities would have resulted in a 30 percent reduction in operating costs. Management could not supply us with sufficient evidence to support this assertion.

[*Same paragraph as third paragraph in examination report in paragraph .18*]

Since we were unable to evaluate management's assumptions regarding the reduction in operating costs and other assumptions related thereto, the scope of our work was not sufficient to express and, therefore, we do not express an opinion on the pro forma adjustments, management's underlying assumptions regarding those adjustments and the application of those adjustments to the historical financial statement amounts in the pro forma condensed financial statement amounts in the pro forma condensed balance sheet as of December 31, 20X1, and the pro forma condensed statement of income for the year then ended.

[*Signature*]

[*Date*]

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[26] This wording is appropriate when one column of pro forma financial information is presented without separate columns of historical financial information and pro forma adjustments.

[27] If either accountant's report includes an explanatory paragraph or is other than unqualified, that fact should be referred to within this report.

[28] If the option in footnote 4 to paragraph .07*a* is followed, the report should be appropriately modified.

AT Section 501

Reporting on an Entity's Internal Control Over Financial Reporting

[This section was superseded effective November 17, 2004 by PCAOB Auditing Standard No. 2. See PCAOB Release No. 2004-008, and SEC Release No. 34-50688.]

AT Section 9501

Reporting on an Entity's Internal Control Over Financial Reporting: Attest Engagements Interpretations of Section 501

[This section was superseded effective November 17, 2004 by PCAOB Auditing Standard No. 2. See PCAOB Release No. 2004-008, and SEC Release No. 34-50688.]

AT Section 601

Compliance Attestation

Source: SSAE No. 10.

Effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001. Earlier application is permitted.

Introduction and Applicability

.01 This section provides guidance for engagements related to either (*a*) an entity's compliance with requirements of specified laws, regulations, rules, contracts, or grants or (*b*) the effectiveness of an entity's internal control over compliance with specified requirements.[1] Compliance requirements may be either financial or nonfinancial in nature. An attest engagement conducted in accordance with this section should comply with the general, fieldwork, and reporting standards in section 101, *Attest Engagements,* and the specific standards set forth in this section.

.02 This section does not—

a. Affect the auditor's responsibility in an audit of financial statements performed in accordance with generally accepted auditing standards (GAAS).

b. Apply to situations in which an auditor reports on specified compliance requirements based solely on an audit of financial statements, as addressed in AU section 623, *Special Reports*, paragraphs .19 through .21.

c. Apply to engagements for which the objective is to report in accordance with AU section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, unless the terms of the engagement specify an attest report under this section.

d. Apply to engagements covered by AU section 634, *Letters for Underwriters and Certain Other Requesting Parties*.

e. Apply to the report that encompasses internal control over compliance for a broker or dealer in securities as required by rule 17a-5 of the Securities Exchange Act of 1934 (the 1934 Act).[2]

.03 A report issued in accordance with the provisions of this section does not provide a legal determination of an entity's compliance with specified requirements. However, such a report may be useful to legal counsel or others in making such determinations.

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[1] Throughout this section—

a. An entity's compliance with requirements of specified laws, regulations, rules, contracts, or grants is referred to as *compliance with specified requirements*.

b. An entity's internal control over compliance with specified requirements is referred to as its *internal control over compliance*. The internal control addressed in this section may include parts of but is not the same as internal control over financial reporting.

[2] An example of this report is contained in the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*.

Scope of Services

.04 The practitioner may be engaged to perform agreed-upon procedures to assist users in evaluating the following subject matter (or assertions related thereto)—

a. The entity's compliance with specified requirements

b. The effectiveness of the entity's internal control over compliance[3]

c. Both the entity's compliance with specified requirements and the effectiveness of the entity's internal control over compliance

The practitioner also may be engaged to examine the entity's compliance with specified requirements or a written assertion thereon.

.05 An important consideration in determining the type of engagement to be performed is expectations by users of the practitioner's report. Since the users decide the procedures to be performed in an agreed-upon procedures engagement, it often will be in the best interests of the practitioner and users (including the client) to have an agreed-upon procedures engagement rather than an examination engagement. When deciding whether to accept an examination engagement, the practitioner should consider the risks discussed in paragraphs .31 through .35.

.06 A practitioner may be engaged to examine the effectiveness of the entity's internal control over compliance or an assertion thereon. However, in accordance with section 101, the practitioner cannot accept an engagement unless he or she has reason to believe that the subject matter is capable of reasonably consistent evaluation against criteria that are suitable and available to users.[4] If a practitioner determines that such criteria do exist for internal control over compliance, he or she should perform the engagement in accordance with section 101. Additionally, section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*, may be helpful to a practitioner in such an engagement.

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[3] An entity's internal control over compliance is the process by which management obtains reasonable assurance of compliance with specified requirements. Although the comprehensive internal control may include a wide variety of objectives and related policies and procedures, only some of these may be relevant to an entity's compliance with specified requirements. (See footnote 1*b*.) The components of internal control over compliance vary based on the nature of the compliance requirements. For example, internal control over compliance with a capital requirement would generally include accounting procedures, whereas internal control over compliance with a requirement to practice nondiscriminatory hiring may not include accounting procedures.

[4] Criteria issued by regulatory agencies and other groups composed of experts that follow due-process procedures, including exposure of the proposed criteria for public comment, ordinarily should be considered suitable criteria for this purpose. For example, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission's Report, *Internal Control—Integrated Framework,* provides suitable criteria against which management may evaluate and report on the effectiveness of the entity's internal control. However, more detailed criteria relative to specific compliance requirements may have to be developed and an appropriate threshold for measuring the severity of control deficiencies needs to be developed in order to apply the concepts of the COSO report to internal control over compliance.

Criteria established by a regulatory agency that does not follow such due-process procedures also may be considered suitable criteria for use by the regulatory agency. The practitioner should determine whether such criteria are suitable for general use reporting by evaluating them against the attributes in section 101.24. If the practitioner determines that such criteria are suitable for general use reporting, those criteria should also be available to users as discussed in section 101.33.

If the practitioner concludes that the criteria are appropriate only for a limited number of parties or are available only to specified parties, the practitioner's report shall state that the use of the report is restricted to those parties specified in the report. (See section 101.30, .34, and .78–.83.)

.07 A practitioner should not accept an engagement to perform a review, as defined in section 101.55, of an entity's compliance with specified requirements or about the effectiveness of an entity's internal control over compliance or an assertion thereon.

.08 The practitioner may be engaged to provide other types of services in connection with the entity's compliance with specified requirements or the entity's internal control over compliance. For example, management may engage the practitioner to provide recommendations on how to improve the entity's compliance or related internal control. A practitioner engaged to provide such nonattest services should refer to the guidance in CS section 100, *Consulting Services: Definitions and Standards*.

Conditions for Engagement Performance

.09 A practitioner may perform an agreed-upon procedures engagement related to an entity's compliance with specified requirements or the effectiveness of internal control over compliance if the following conditions are met.

a. The responsible party accepts responsibility for the entity's compliance with specified requirements and the effectiveness of the entity's internal control over compliance.

b. The responsible party evaluates the entity's compliance with specified requirements or the effectiveness of the entity's internal control over compliance.

See also section 201, *Agreed-Upon Procedures Engagements*.

.10 A practitioner may perform an examination engagement related to an entity's compliance with specified requirements if the following conditions are met.

a. The responsible party accepts responsibility for the entity's compliance with specified requirements and the effectiveness of the entity's internal control over compliance.

b. The responsible party evaluates the entity's compliance with specified requirements.

c. Sufficient evidential matter exists or could be developed to support management's evaluation.

.11 As part of engagement performance, the practitioner should obtain from the responsible party a written assertion about compliance with specified requirements or internal control over compliance. The responsible party may present its written assertion in either of the following:

a. A separate report that will accompany the practitioner's report

b. A representation letter to the practitioner

.12 The responsible party's written assertion about compliance with specified requirements or internal control over compliance may take many forms. Throughout this section, for example, the phrase "responsible party's assertion that W Company complied with [*specify compliance requirement*] as of [*date*]," illustrates such an assertion. Other phrases may also be used. However, a practitioner should not accept an assertion that is so subjective (for example, "very

effective" internal control over compliance) that people having competence in and using the same or similar criteria would not ordinarily be able to arrive at similar conclusions.

.13 Regardless of whether the practitioner's client is the responsible party, the responsible party's refusal to furnish a written assertion as part of an examination engagement should cause the practitioner to withdraw from the engagement. However, an exception is provided if an examination of an entity's compliance with specified requirements is required by law or regulation. In that instance, the practitioner should disclaim an opinion on compliance unless he or she obtains evidential matter that warrants expressing an adverse opinion. If the practitioner expresses an adverse opinion and the responsible party does not provide an assertion, the practitioner's report should be restricted as to use. (See section 101.78–.81.) If, as part of an agreed-upon procedures engagement, the practitioner's client is the responsible party, a refusal by that party to provide an assertion requires the practitioner to withdraw from the engagement. However, withdrawal is not required if the engagement is required by law or regulation. If, in an agreed-upon procedures engagement, the practitioner's client is not the responsible party, the practitioner is not required to withdraw but should consider the effects of the responsible party's refusal on the engagement and his or her report.

.14 Additionally, at the beginning of the engagement, the practitioner may want to consider discussing with the client and the responsible party the need for the responsible party to provide the practitioner with a written representation letter at the conclusion of the examination engagement or an agreed-upon procedures engagement in which the client is the responsible party. In that letter, the responsible party will be asked to provide, among other possible items, an acknowledgment of their responsibility for establishing and maintaining effective internal control over compliance and their assertion stating their evaluation of the entity's compliance with specified requirements. The responsible party's refusal to furnish these representations (see paragraphs .68 through .70) will constitute a limitation on the scope of the engagement.

Responsible Party

.15 The responsible party is responsible for ensuring that the entity complies with the requirements applicable to its activities. That responsibility encompasses the following.

a. Identify applicable compliance requirements.

b. Establish and maintain internal control to provide reasonable assurance that the entity complies with those requirements.

c. Evaluate and monitor the entity's compliance.

d. Specify reports that satisfy legal, regulatory, or contractual requirements.

The responsible party's evaluation may include documentation such as accounting or statistical data, entity policy manuals, accounting manuals, narrative memoranda, procedural write-ups, flowcharts, completed questionnaires, or internal auditors' reports. The form and extent of documentation will vary depending on the nature of the compliance requirements and the size and

complexity of the entity. The responsible party may engage the practitioner to gather information to assist it in evaluating the entity's compliance. Regardless of the procedures performed by the practitioner, the responsible party must accept responsibility for its assertion and must not base such assertion solely on the practitioner's procedures.

Agreed-Upon Procedures Engagement

.16 The objective of the practitioner's agreed-upon procedures is to present specific findings to assist users in evaluating an entity's compliance with specified requirements or the effectiveness of an entity's internal control over compliance based on procedures agreed upon by the users of the report. A practitioner engaged to perform agreed-upon procedures on an entity's compliance with specified requirements or about the effectiveness of an entity's internal control over compliance should follow the guidance set forth herein and in section 201.

.17 The practitioner's procedures generally may be as limited or as extensive as the specified users desire, as long as the specified users (*a*) agree upon the procedures performed or to be performed and (*b*) take responsibility for the sufficiency of the agreed-upon procedures for their purposes. (See section 201.15.)

.18 To satisfy the requirements that the practitioner and the specified users agree upon the procedures performed or to be performed and that the specified users take responsibility for the sufficiency of the agreed-upon procedures for their purposes, ordinarily the practitioner should communicate directly with and obtain affirmative acknowledgment from each of the specified users. For example, this may be accomplished by meeting with the specified users or by distributing a draft of the anticipated report or a copy of an engagement letter to the specified users and obtaining their agreement. If the practitioner is not able to communicate directly with all of the specified users, the practitioner may satisfy these requirements by applying any one or more of the following or similar procedures.

- Compare the procedures to be applied to written requirements of the specified users.
- Discuss the procedures to be applied with appropriate representatives of the specified users involved.
- Review relevant contracts with or correspondence from the specified users.

The practitioner should not report on an engagement when specified users do not agree upon the procedures performed or to be performed and do not take responsibility for the sufficiency of the procedures for their purposes. See section 201.36 for guidance on satisfying these requirements when the practitioner is requested to add other parties as specified parties after the date of completion of the agreed-upon procedures.

.19 In an engagement to perform agreed-upon procedures on an entity's compliance with specified requirements or about the effectiveness of an entity's internal control over compliance, the practitioner is required to perform only the procedures that have been agreed to by users.[5] However, prior to performing

[5] AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, does not apply to agreed-upon procedures engagements.

such procedures, the practitioner should obtain an understanding of the specified compliance requirements, as discussed in paragraph .20. (See section 201.)

.20 To obtain an understanding of the specified compliance requirements, a practitioner should consider the following:

a. Laws, regulations, rules, contracts, and grants that pertain to the specified compliance requirements, including published requirements

b. Knowledge about the specified compliance requirements obtained through prior engagements and regulatory reports

c. Knowledge about the specified compliance requirements obtained through discussions with appropriate individuals within the entity (for example, the chief financial officer, internal auditors, legal counsel, compliance officer, or grant or contract administrators)

d. Knowledge about the specified compliance requirements obtained through discussions with appropriate individuals outside the entity (for example, a regulator or a third-party specialist)

.21 When circumstances impose restrictions on the scope of an agreed-upon procedures engagement, the practitioner should attempt to obtain agreement from the users for modification of the agreed-upon procedures. When such agreement cannot be obtained (for example, when the agreed-upon procedures are published by a regulatory agency that will not modify the procedures), the practitioner should describe such restrictions in his or her report or withdraw from the engagement.

.22 The practitioner has no obligation to perform procedures beyond the agreed-upon procedures. However, if noncompliance comes to the practitioner's attention by other means, such information ordinarily should be included in his or her report.

.23 The practitioner may become aware of noncompliance that occurs subsequent to the period addressed by the practitioner's report but before the date of the practitioner's report. The practitioner should consider including information regarding such noncompliance in his or her report. However, the practitioner has no responsibility to perform procedures to detect such noncompliance other than obtaining the responsible party's representation about noncompliance in the subsequent period, as described in paragraph .68.

.24 The practitioner's report on agreed-upon procedures on an entity's compliance with specified requirements (or the effectiveness of an entity's internal control over compliance) should be in the form of procedures and findings. The practitioner's report should contain the following elements:

a. A title that includes the word *independent*

b. Identification of the specified parties

c. Identification of the subject matter of the engagement (or management's assertion thereon), including the period or point in time addressed and a reference to the character of the engagement[6]

d. An identification of the responsible party

[6] Generally, management's assertion about compliance with specified requirements will address a *period* of time, whereas an assertion about internal control over compliance will address a *point* in time.

e. A statement that the subject matter is the responsibility of the responsible party

f. A statement that the procedures, which were agreed to by the specified parties identified in the report, were performed to assist the specified parties in evaluating the entity's compliance with specified requirements or the effectiveness of its internal control over compliance

g. A statement that the agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants

h. A statement that the sufficiency of the procedures is solely the responsibility of the specified parties and a disclaimer of responsibility for the sufficiency of those procedures

i. A list of the procedures performed (or reference thereto) and related findings (The practitioner should not provide negative assurance. See section 201.24.)

j. Where applicable, a description of any agreed-upon materiality limits (See section 201.25.)

k. A statement that the practitioner was not engaged to and did not conduct an examination of the entity's compliance with specified requirements (or the effectiveness of an entity's internal control over compliance), a disclaimer of opinion thereon, and a statement that if the practitioner had performed additional procedures, other matters might have come to his or her attention that would have been reported

l. A statement restricting the use of the report to the specified parties

m. Where applicable, reservations or restrictions concerning procedures or findings as discussed in section 201.33, .35, .39, and .40

n. Where applicable, a description of the nature of the assistance provided by the specialist as discussed in section 201.19–.21

o. The manual or printed signature of the practitioner's firm

p. The date of the report

.25 The following is an illustration of an agreed-upon procedures report on an entity's compliance with specified requirements in which the procedures and findings are enumerated rather than referenced.

Independent Accountant's Report on Applying Agreed-Upon Procedures

We have performed the procedures enumerated below, which were agreed to by [*list specified parties*], solely to assist the specified parties in evaluating [*name of entity*]'s compliance with [*list specified requirements*] during the [*period*] ended [*date*].[7] Management is responsible for [*name of entity*]'s compliance with those requirements. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below

[7] If the agreed-upon procedures have been published by a third-party user (for example, a regulator in regulatory policies or a lender in a debt agreement), this sentence might begin, "We have performed the procedures included in [*title of publication or other document*] and enumerated below, which were agreed to by [*list specified parties*], solely to assist the specified parties in evaluating ...."

either for the purpose for which this report has been requested or for any other purpose.

[*Include paragraphs to enumerate procedures and findings.*]

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on compliance. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of [*list or refer to specified parties*] and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

.26 Evaluating compliance with certain requirements may require interpretation of the laws, regulations, rules, contracts, or grants that establish those requirements. In such situations, the practitioner should consider whether he or she is provided with the suitable criteria required to evaluate an assertion under the third general attestation standard. If these interpretations are significant, the practitioner may include a paragraph stating the description and the source of interpretations made by the entity's management. An example of such a paragraph, which should precede the procedures and findings paragraph(s), follows.

We have been informed that, under [*name of entity*]'s interpretation of [*identify the compliance requirement*], [*explain the nature and source of the relevant interpretation*].

.27 The following is an illustration of an agreed-upon procedures report on the effectiveness of an entity's internal control over compliance in which the procedures and findings are enumerated rather than referenced.

Independent Accountant's Report on Applying Agreed-Upon Procedures

We have performed the procedures enumerated below, which were agreed to by [*list specified parties*], solely to assist the specified parties in evaluating the effectiveness of [*name of entity*]'s internal control over compliance with [*list specified requirements*] as of [*date*].[8] Management is responsible for [*name of entity*]'s internal control over compliance with those requirements. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

[*Include paragraphs to enumerate procedures and findings.*]

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

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[8] If the agreed-upon procedures have been published by a third-party user (for example, a regulator in regulatory policies or a lender in a debt agreement), this sentence might begin, "We have performed the procedures included in [*title of publication or other document*] and enumerated below, which were agreed to by [*list specified parties*], solely to assist the specified parties in evaluating the effectiveness of [*name of entity*]'s internal control over compliance ...."

This report is intended solely for the information and use of [*list or refer to specified parties*] and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

.28 In some agreed-upon procedures engagements, procedures may relate to both compliance with specified requirements and the effectiveness of internal control over compliance. In these engagements, the practitioner may issue one report that addresses both. For example, the first sentence of the introductory paragraph would state the following.

> We have performed the procedures enumerated below, which were agreed to by [*list users of report*], solely to assist the users in evaluating [*name of entity*]'s compliance with [*list specified requirements*] during the [*period*] ended [*date*] and the effectiveness of [*name of entity*]'s internal control over compliance with the aforementioned compliance requirements as of [*date*].

.29 The date of completion of the agreed-upon procedures should be used as the date of the practitioner's report.

Examination Engagement

.30 The objective of the practitioner's examination procedures applied to an entity's compliance with specified requirements is to express an opinion on an entity's compliance (or assertion related thereto), based on the specified criteria. To express such an opinion, the practitioner accumulates sufficient evidence about the entity's compliance with specified requirements, thereby restricting attestation risk to an appropriately low level.

Attestation Risk

.31 In an engagement to examine compliance with specified requirements, the practitioner seeks to obtain reasonable assurance that the entity complied, in all material respects, based on the specified criteria. This includes designing the examination to detect both intentional and unintentional material noncompliance. Absolute assurance is not attainable because of factors such as the need for judgment, the use of sampling, and the inherent limitations of internal control over compliance and because much of the evidence available to the practitioner is persuasive rather than conclusive in nature. Also, procedures that are effective for detecting noncompliance that is unintentional may be ineffective for detecting noncompliance that is intentional and concealed through collusion between personnel of the entity and a third party or among management or employees of the entity. Therefore, the subsequent discovery that material noncompliance exists does not, in and of itself, evidence inadequate planning, performance, or judgment on the part of the practitioner.

.32 Attestation risk is the risk that the practitioner may unknowingly fail to modify appropriately his or her opinion. It is composed of inherent risk, control risk, and detection risk. For purposes of a compliance examination, these components are defined as follows:

a. *Inherent risk*—The risk that material noncompliance with specified requirements could occur, assuming there are no related controls

b. *Control risk*—The risk that material noncompliance that could occur will not be prevented or detected on a timely basis by the entity's controls

c. *Detection risk*—The risk that the practitioner's procedures will lead him or her to conclude that material noncompliance does not exist when, in fact, such noncompliance does exist

Inherent Risk

.33 In assessing inherent risk, the practitioner should consider factors affecting risk similar to those an auditor would consider when planning an audit of financial statements. Such factors are discussed in AU section 316A, *Consideration of Fraud in a Financial Statement Audit*, paragraphs .16 through .19. In addition, the practitioner should consider factors relevant to compliance engagements, such as the following:

- The complexity of the specified compliance requirements
- The length of time the entity has been subject to the specified compliance requirements
- Prior experience with the entity's compliance
- The potential impact of noncompliance

Control Risk

.34 The practitioner should assess control risk as discussed in paragraphs .45 and .46. Assessing control risk contributes to the practitioner's evaluation of the risk that material noncompliance exists. The process of assessing control risk (together with assessing inherent risk) provides evidential matter about the risk that such noncompliance may exist. The practitioner uses this evidential matter as part of the reasonable basis for his or her opinion.

Detection Risk

.35 In determining an acceptable level of detection risk, the practitioner assesses inherent risk and control risk and considers the extent to which he or she seeks to restrict attestation risk. As assessed inherent risk or control risk decreases, the acceptable level of detection risk increases. Accordingly, the practitioner may alter the nature, timing, and extent of compliance tests performed based on the assessments of inherent risk and control risk.

Materiality

.36 In an examination of an entity's compliance with specified requirements, the practitioner's consideration of materiality differs from that of an audit of financial statements in accordance with GAAS. In an examination of an entity's compliance with specified requirements, the practitioner's consideration of materiality is affected by (*a*) the nature of the compliance requirements, which may or may not be quantifiable in monetary terms, (*b*) the nature and frequency of noncompliance identified with appropriate consideration of sampling risk, and (*c*) qualitative considerations, including the needs and expectations of the report's users.

.37 In a number of situations, the terms of the engagement may provide for a supplemental report of all or certain noncompliance discovered. Such terms should not change the practitioner's judgments about materiality in planning and performing the engagement or in forming an opinion on an entity's

compliance with specified requirements or on the responsible party's assertion about such compliance.

Performing an Examination Engagement

.38 The practitioner should exercise (*a*) due care in planning, performing, and evaluating the results of his or her examination procedures and (*b*) the proper degree of professional skepticism to achieve reasonable assurance that material noncompliance will be detected.

.39 In an examination of the entity's compliance with specified requirements, the practitioner should—

a. Obtain an understanding of the specified compliance requirements. (See paragraph .40.)

b. Plan the engagement. (See paragraphs .41 through .44.)

c. Consider relevant portions of the entity's internal control over compliance. (See paragraphs .45 through .47.)

d. Obtain sufficient evidence including testing compliance with specified requirements. (See paragraphs .48 and .49.)

e. Consider subsequent events. (See paragraphs .50 through .52.)

f. Form an opinion about whether the entity complied, in all material respects, with specified requirements (or whether the responsible party's assertion about such compliance is fairly stated in all material respects), based on the specified criteria. (See paragraph .53.)

Obtaining an Understanding of the Specified Compliance Requirements

.40 A practitioner should obtain an understanding of the specified compliance requirements. To obtain such an understanding, a practitioner should consider the following:

a. Laws, regulations, rules, contracts, and grants that pertain to the specified compliance requirements, including published requirements

b. Knowledge about the specified compliance requirements obtained through prior engagements and regulatory reports

c. Knowledge about the specified compliance requirements obtained through discussions with appropriate individuals within the entity (for example, the chief financial officer, internal auditors, legal counsel, compliance officer, or grant or contract administrators)

d. Knowledge about the specified compliance requirements obtained through discussions with appropriate individuals outside the entity (for example, a regulator or third-party specialist)

Planning the Engagement

General Considerations

.41 Planning an engagement to examine an entity's compliance with specified requirements involves developing an overall strategy for the expected conduct and scope of the engagement. The practitioner should consider the planning matters discussed in section 101.42–.47.

Multiple Components

.42 In an engagement to examine an entity's compliance with specified requirements when the entity has operations in several components (for example, locations, branches, subsidiaries, or programs), the practitioner may determine that it is not necessary to test compliance with requirements at every component. In making such a determination and in selecting the components to be tested, the practitioner should consider factors such as the following:

a. The degree to which the specified compliance requirements apply at the component level

b. Judgments about materiality

c. The degree of centralization of records

d. The effectiveness of the control environment, particularly management's direct control over the exercise of authority delegated to others and its ability to supervise activities at various locations effectively

e. The nature and extent of operations conducted at the various components

f. The similarity of operations over compliance for different components

Using the Work of a Specialist

.43 In some compliance engagements, the nature of the specified compliance requirements may require specialized skill or knowledge in a particular field other than accounting or auditing. In such cases, the practitioner may use the work of a specialist and should follow the relevant performance and reporting guidance in AU section 336, *Using the Work of a Specialist*.

Internal Audit Function

.44 Another factor the practitioner should consider when planning the engagement is whether the entity has an internal audit function and the extent to which internal auditors are involved in monitoring compliance with the specified requirements. A practitioner should consider the guidance in AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, when addressing the competence and objectivity of internal auditors, the nature, timing, and extent of work to be performed, and other related matters.

Consideration of Internal Control Over Compliance

.45 The practitioner should obtain an understanding of relevant portions of internal control over compliance sufficient to plan the engagement and to assess control risk for compliance with specified requirements. In planning the examination, such knowledge should be used to identify types of potential noncompliance, to consider factors that affect the risk of material noncompliance, and to design appropriate tests of compliance.

.46 A practitioner generally obtains an understanding of the design of specific controls by performing the following:

a. Inquiries of appropriate management, supervisory, and staff personnel

b. Inspection of the entity's documents

c. Observation of the entity's activities and operations

The nature and extent of procedures a practitioner performs vary from entity to entity and are influenced by factors such as the following:

- The newness and complexity of the specified requirements
- The practitioner's knowledge of internal control over compliance obtained in previous professional engagements
- The nature of the specified compliance requirements
- An understanding of the industry in which the entity operates
- Judgments about materiality

When seeking to assess control risk below the maximum, the practitioner should perform tests of controls to obtain evidence to support the assessed level of control risk.

.47 During the course of an examination engagement, the practitioner may become aware of significant deficiencies in the design or operation of internal control over compliance that could adversely affect the entity's ability to comply with specified requirements. A practitioner's responsibility to communicate these deficiencies in an examination of an entity's compliance with specified requirements is similar to the auditor's responsibility described in AU section 325, *Communication of Internal Control Related Matters Noted in an Audit*. If, in a multiple-party arrangement, the practitioner's client is not the responsible party, the practitioner has no responsibility to communicate reportable conditions to the responsible party. For example, if the practitioner is engaged by his or her client to examine the compliance of another entity, the practitioner has no obligation to communicate any reportable conditions that he or she becomes aware of to the other entity. However, the practitioner is not precluded from making such a communication.

Obtaining Sufficient Evidence

.48 The practitioner should apply procedures to provide reasonable assurance of detecting material noncompliance. Determining these procedures and evaluating the sufficiency of the evidence obtained are matters of professional judgment. When exercising such judgment, practitioners should consider the guidance contained in section 101.51–.54 and AU section 350, *Audit Sampling*.

.49 For engagements involving compliance with regulatory requirements, the practitioner's procedures should include reviewing reports of significant examinations and related communications between regulatory agencies and the entity and, when appropriate, making inquiries of the regulatory agencies, including inquiries about examinations in progress.

Consideration of Subsequent Events

.50 The practitioner's consideration of subsequent events in an examination of an entity's compliance with specified requirements is similar to the auditor's consideration of subsequent events in a financial statement audit, as outlined in AU section 560, *Subsequent Events*. The practitioner should consider information about such events that comes to his or her attention after the end of the period addressed by the practitioner's report and prior to the issuance of his or her report.

.51 Two types of subsequent events require consideration by the responsible party and evaluation by the practitioner. The first consists of events that provide additional information about the entity's compliance during the period addressed by the practitioner's report and may affect the practitioner's report. For the period from the end of the reporting period (or point in time) to the date of the practitioner's report, the practitioner should perform procedures to identify such events that provide additional information about compliance during the reporting period. Such procedures should include but may not be limited to inquiring about and considering the following information:

- Relevant internal auditors' reports issued during the subsequent period
- Other practitioners' reports identifying noncompliance, issued during the subsequent period
- Regulatory agencies' reports on the entity's noncompliance, issued during the subsequent period
- Information about the entity's noncompliance, obtained through other professional engagements for that entity

.52 The second type consists of noncompliance that occurs subsequent to the period being reported on but before the date of the practitioner's report. The practitioner has no responsibility to detect such noncompliance. However, should the practitioner become aware of such noncompliance, it may be of such a nature and significance that disclosure of it is required to keep users from being misled. In such cases, the practitioner should include in his or her report an explanatory paragraph describing the nature of the noncompliance.

Forming an Opinion

.53 In evaluating whether the entity has complied in all material respects (or whether the responsible party's assertion about such compliance is stated fairly in all material respects), the practitioner should consider (*a*) the nature and frequency of the noncompliance identified and (*b*) whether such noncompliance is material relative to the nature of the compliance requirements, as discussed in paragraph .36.

Reporting

.54 The practitioner may examine and report directly on an entity's compliance (see paragraphs .55 and .56) or he or she may examine and report on the responsible party's written assertion (see paragraphs .57, .58, and .61), except as described in paragraph .64.

.55 The practitioner's examination report on compliance, which is ordinarily addressed to the entity, should include the following:

a. A title that includes the word *independent*

b. Identification of the specified compliance requirements, including the period covered, and of the responsible party[9]

[9] A practitioner also may be engaged to report on an entity's compliance with specified requirements as of point in time. In this case, the illustrative reports in this section should be adapted as appropriate.

c. A statement that compliance with the specified requirements is the responsibility of the entity's management

d. A statement that the practitioner's responsibility is to express an opinion on the entity's compliance with those requirements based on his or her examination

e. A statement that the examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the entity's compliance with those requirements and performing such other procedures as the practitioner considered necessary in the circumstances

f. A statement that the practitioner believes the examination provides a reasonable basis for his or her opinion

g. A statement that the examination does not provide a legal determination on the entity's compliance

h. The practitioner's opinion on whether the entity complied, in all material respects, with specified requirements based on the specified criteria[10] (See paragraph .64 for reporting on material noncompliance.)

i. A statement restricting the use of the report to the specified parties (see the fourth reporting standard)[11] under the following circumstances (See also paragraph .13.):

- When the criteria used to evaluate compliance are determined by the practitioner to be appropriate only for a limited number of parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria.
- When the criteria used to evaluate compliance are available only to the specified parties

j. The manual or printed signature of the practitioner's firm

k. The date of the examination report

.56 The following is the form of report a practitioner should use when he or she is expressing an opinion on an entity's compliance with specified requirements during a period of time.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined [*name of entity*]'s compliance with [*list specified compliance requirements*] during the [*period*] ended [*date*]. Management is responsible for [*name of entity*]'s compliance with those requirements. Our responsibility is to express an opinion on [*name of entity*]'s compliance based on our examination.

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[10] Frequently, criteria will be contained in the compliance requirements, in which case it is not necessary to repeat the criteria in the practitioner's report; however, if the criteria are not included in the compliance requirement, the practitioner's report should identify the criteria. For example, if a compliance requirement is to "maintain $25,000 in capital," it would not be necessary to identify the $25,000 in the report; however, if the requirement is to "maintain adequate capital," the practitioner should identify the criteria used to define *adequate.*

[11] In certain situations, however, criteria that have been specified by management and other report users may be suitable for general use.

[*Scope paragraph*]

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about [*name of entity*]'s compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Our examination does not provide a legal determination on [*name of entity*]'s compliance with specified requirements.

[*Opinion paragraph*]

In our opinion, [*name of entity*] complied, in all material respects, with the aforementioned requirements for the year ended December 31, 20XX.[12]

[*Signature*]

[*Date*]

.57 The practitioner's examination report on an entity's assertion about compliance with specified requirements, which is ordinarily addressed to the entity, should include the following:

a. A title that includes the word *independent*

b. Identification of the responsible party's assertion about the entity's compliance with specified requirements, including the period covered by the responsible party's assertion, and of the responsible party (When the responsible party's assertion does not accompany the practitioner's report, the first paragraph of the report should also contain a statement of the responsible party's assertion.)[13]

c. A statement that compliance with the requirements is the responsibility of the entity's management

d. A statement that the practitioner's responsibility is to express an opinion on the responsible party's assertion on the entity's compliance with those requirements based on his or her examination

e. A statement that the examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the entity's compliance with those requirements and performing such other procedures as the practitioner considered necessary in the circumstances

f. A statement that the practitioner believes the examination provides a reasonable basis for his or her opinion

g. A statement that the examination does not provide a legal determination on the entity's compliance

h. The practitioner's opinion on whether the responsible party's assertion about compliance with specified requirements is fairly

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[12] If it is necessary to identify criteria (see footnote 10), the criteria should be identified in the opinion paragraph (for example, "... in all material respects, based on the criteria set forth in Attachment 1").

[13] A practitioner also may be engaged to report on the responsible party's assertion about an entity's compliance with specified requirements as of a point in time. In this case, the illustrative reports in this section should be adapted as appropriate.

stated in all material respects based on the specified criteria[14] (See paragraph .64 for reporting on material noncompliance.)

i. A statement restricting the use of the report to the specified parties (see the fourth reporting standard)[15,16] under the following circumstances:

- When the criteria used to evaluate compliance are determined by the practitioner to be appropriate only for a limited number of parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria
- When the criteria used to evaluate compliance are available only to the specified parties

j. The manual or printed signature of the practitioner's firm

k. The date of the examination report

.58 The following is the form of report that a practitioner should use when expressing an opinion on management's assertion about compliance with specified requirements.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion, included in the accompanying [*title of management report*], that [*name of entity*] complied with [*list specified compliance requirements*] during the [*period*] ended [*date*].[17,18] Management is responsible for [*name of entity*]'s compliance with those requirements. Our responsibility is to express an opinion on management's assertion about [*name of entity*]'s compliance based on our examination.

[*Standard scope paragraph*]

[*Opinion paragraph*]

In our opinion, management's assertion that [*name of entity*] complied with the aforementioned requirements during the [*period*] ended [*date*] is fairly stated, in all material respects.[19]

[*Signature*]

[*Date*]

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[14] Frequently, criteria will be contained in the compliance requirements, in which case it is not necessary to repeat the criteria in the practitioner's report; however, if the criteria are not included in the compliance requirement, the practitioner's report should identify the criteria. For example, if a compliance requirement is to "maintain $25,000 in capital," it would not be necessary to identify the $25,000 in the report; however, if the requirement is to "maintain adequate capital," the practitioner should identify the criteria used to define *adequate*.

[15] Although a practitioner's report may be appropriate for general use, the practitioner is not precluded from restricting the use of the report.

[16] In certain situations, however, criteria that have been specified by management and other report users may be suitable for general use.

[17] The practitioner should identify the management report examined by reference to the report title used by management in its report. Further, he or she should use the same description of compliance requirements as management uses in its report.

[18] If management's assertion is stated in the practitioner's report and does not accompany the practitioner's report, the phrase "included in the accompanying [*title of management report*]" would be omitted.

[19] If it is necessary to identify criteria (see footnote 10), the criteria should be identified in the opinion paragraph (for example, "...in all material respects, based on the criteria set forth in Attachment 1").

.59 Evaluating compliance with certain requirements may require interpretation of the laws, regulations, rules, contracts, or grants that establish those requirements. In such situations, the practitioner should consider whether he or she is provided with the suitable criteria required to evaluate compliance under the third general attestation standard. If these interpretations are significant, the practitioner may include a paragraph stating the description and the source of interpretations made by the entity's management. The following is an example of such a paragraph, which should directly follow the scope paragraph:

We have been informed that, under [*name of entity*]'s interpretation of [*identify the compliance requirement*], [*explain the source and nature of the relevant interpretation*].

.60 The date of completion of the examination procedures should be used as the date of the practitioner's report.

.61 Nothing precludes the practitioner from examining an assertion but opining directly on compliance.

.62 Section 101.78–.83 provide guidance on restricting the use of an attest report. Nothing in this section precludes the practitioner from restricting the use of the report. For example, if the practitioner is asked by a client to examine another entity's compliance with certain regulations, he or she may want to restrict the use of the report to the client since the practitioner has no control over how the report may be used by the other entity.

Report Modifications

.63 The practitioner should modify the standard report described in paragraphs .55 and .57, if any of the following conditions exist.

- There is material noncompliance with specified requirements (paragraphs .64 through .67).
- There is a restriction on the scope of the engagement.[20]
- The practitioner decides to refer to the report of another practitioner as the basis, in part, for the practitioner's report.[21]

Material Noncompliance

.64 When an examination of an entity's compliance with specified requirements discloses noncompliance with the applicable requirements that the practitioner believes have a material effect on the entity's compliance, the practitioner should modify the report and, to most effectively communicate with the reader of the report, should state his or her opinion on the entity's specified compliance requirements, not on the responsible party's assertion.

.65 The following is the form of report, modified with explanatory language, that a practitioner should use when he or she has concluded that a qualified opinion is appropriate under the circumstances. It has been assumed that the

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[20] The practitioner should refer to section 101.73 and .74 for guidance on scope restrictions.

[21] The practitioner should refer to section 501.63 and .64[§] for guidance on an opinion based in part on the report of another practitioner and adapt such guidance to the standard reports in this section.

practitioner has determined that the specified compliance requirements are both suitable for general use and available to users as discussed in section 101.23–.33, and, therefore, that a restricted use paragraph is not required.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined [*name of entity*]'s compliance with [*list specified compliance requirements*] for the [*period*] ended [*date*]. Management is responsible for compliance with those requirements. Our responsibility is to express an opinion on [*name of entity*]'s compliance based on our examination.

[*Standard scope paragraph*]

[*Explanatory paragraph*]

Our examination disclosed the following material noncompliance with [*type of compliance requirement*] applicable to [*name of entity*] during the [*period*] ended [*date*]. [*Describe noncompliance.*]

[*Opinion paragraph*]

In our opinion, except for the material noncompliance described in the third paragraph, [*name of entity*] complied, in all material respects, with the aforementioned requirements for the [*period*] ended [*date*].

[*Signature*]

[*Date*]

.66 The following is the form of report, modified with explanatory language, that a practitioner should use when he or she concludes that an adverse opinion is appropriate in the circumstances. The practitioner has determined that the specified compliance requirements are both suitable for general use and available to users as discussed in section 101.23–.33.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined [*name of entity*]'s compliance with [*list specified compliance requirements*] for the [*period*] ended [*date*]. Management is responsible for compliance with those requirements. Our responsibility is to express an opinion on [*name of entity*]'s compliance based on our examination.

[*Standard scope paragraph*]

[*Explanatory paragraph*]

Our examination disclosed the following material noncompliance with [*type of compliance requirement*] applicable to [*name of entity*] during the [*period*] ended [*date*]. [*Describe noncompliance.*]

[*Opinion paragraph*]

In our opinion, because of the effect of the noncompliance described in the third paragraph, [*name of entity*] has not complied with the aforementioned requirements for the [*period*] ended [*date*].

[*Signature*]

[*Date*]

.67 If the practitioner's report on his or her examination of the entity's compliance with specified requirements is included in a document that also includes his or her audit report on the entity's financial statements, the following sentence should be included in the paragraph of an examination report that describes material noncompliance.

These conditions were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20XX financial statements, and this report does not affect our report dated [*date of report*] on those financial statements.

The practitioner also may include the preceding sentence when the two reports are not included within the same document.

Representation Letter

.68 In an examination engagement or an agreed-upon procedures engagement, the practitioner should obtain written representations from the responsible party—[22]

a. Acknowledging the responsible party's responsibility for complying with the specified requirements.

b. Acknowledging the responsible party's responsibility for establishing and maintaining effective internal control over compliance.

c. Stating that the responsible party has performed an evaluation of (1) the entity's compliance with specified requirements or (2) the entity's controls for ensuring compliance and detecting noncompliance with requirements, as applicable.

d. Stating the responsible party's assertion about the entity's compliance with the specified requirements or about the effectiveness of internal control over compliance, as applicable, based on the stated or established criteria.

e. Stating that the responsible party has disclosed to the practitioner all known noncompliance.

f. State that the responsible party has made available all documentation related to compliance with the specified requirements.

g. Stating the responsible party's interpretation of any compliance requirements that have varying interpretations.

h. State that the responsible party has disclosed any communications from regulatory agencies, internal auditors, and other practitioners concerning possible noncompliance with the specified requirements, including communications received between the end of the period addressed in the written assertion and the date of the practitioner's report.

i. Stating that the responsible party has disclosed any known noncompliance occurring subsequent to the period for which, or date as of which, the responsible party selects to make its assertion.

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[22] AU section 333, *Management Representations*, paragraph .09, provides guidance on the date as of which the representation letter should be signed and who should sign it.

.69 The responsible party's refusal to furnish all appropriate written representations in an examination engagement constitutes a limitation on the scope of the engagement sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause the practitioner to disclaim an opinion or withdraw from the engagement. However, based on the nature of the representations not obtained or the circumstances of the refusal, the practitioner may conclude in an examination engagement that a qualified opinion is appropriate. When the practitioner is performing agreed-upon procedures and the practitioner's client is the responsible party, the responsible party's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the engagement sufficient to cause the practitioner to withdraw. When the practitioner's client is not the responsible party, the practitioner is not required to withdraw but should consider the effects of the responsible party's refusal on his or her report. Further, the practitioner should consider the effects of the responsible party's refusal on his or her ability to rely on other representations of the responsible party.

.70 When the practitioner's client is not the responsible party, the practitioner may also want to obtain written representations from the client. For example, when a practitioner's client has entered into a contract with a third party (responsible party) and the practitioner is engaged to examine the responsible party's compliance with that contract, the practitioner may want to obtain written representations from his or her client as to their knowledge of any noncompliance.

Other Information in a Client-Prepared Document Containing Management's Assertion About the Entity's Compliance With Specified Requirements or the Effectiveness of the Internal Control Over Compliance

.71 An entity may publish various documents that contain information (referred to as *other information*) in addition to the practitioner's attest report on either (*a*) the entity's compliance with specified requirements or (*b*) the effectiveness of the entity's internal control over compliance or written assertion thereon. Section 101.91–.94 provide guidance to the practitioner if the other information is contained in either of the following:

a. Annual reports to holders of securities or beneficial interests, annual reports of organizations for charitable or philanthropic purposes distributed to the public, and annual reports filed with regulatory authorities under the 1934 Act

b. Other documents to which the practitioner, at the client's request, devotes attention

Effective Date

.72 This section is effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001. Early application is permitted.

AT Section 701

Management's Discussion and Analysis

Source: SSAE No. 10.

Effective when management's discussion and analysis is for a period ending on or after June 1, 2001. Earlier application is permitted.

General

.01 This section sets forth attestation standards and provides guidance to a practitioner concerning the performance of an attest engagement[1] with respect to management's discussion and analysis (MD&A) prepared pursuant to the rules and regulations adopted by the Securities and Exchange Commission (SEC), which are presented in annual reports to shareholders and in other documents.[2]

Applicability

.02 This section is applicable to the following levels of service when a practitioner is engaged by (*a*) a public[3] entity that prepares MD&A in accordance with the rules and regulations adopted by the SEC (see paragraph .04) or (*b*) a nonpublic entity that prepares an MD&A presentation and whose management provides a written assertion that the presentation has been prepared using the rules and regulations adopted by the SEC:[4]

- An examination of an MD&A presentation
- A review of an MD&A presentation for an annual period, an interim period, or a combined annual and interim period[5]

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[1] Section 101, *Attest Engagements*, paragraph .01, defines an attest engagement as one in which a practitioner "is engaged to issue or does issue an examination, a review, or an agreed-upon procedures report on subject matter, or an assertion about the subject matter (hereafter referred to as the *assertion*), that is the responsibility of another party."

[2] Because this section provides guidance specific to attest engagements concerning MD&A presentations, a practitioner should not perform a compliance attestation engagement under section 601, *Compliance Attestation*, with respect to an MD&A presentation.

[3] For purposes of this section, a public entity is any entity (*a*) whose securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter (OTC) market, including securities quoted only locally or regionally, (*b*) that makes a filing with a regulatory agency in preparation for the sale of any class of its securities in a public market, or (*c*) a subsidiary, corporate joint venture, or other entity controlled by an entity covered by (*a*) or (*b*).

[4] Such assertion may be made by any of the following:

(*a*) Including a statement in the body of the MD&A presentation that it has been prepared using the rules and regulations adopted by the SEC.
(*b*) Providing a separate written assertion to accompany the MD&A presentation.
(*c*) Providing a written assertion in a representation letter to the practitioner.

[5] As discussed in paragraph .85*k*, a review report is not intended to be filed with the SEC as a report under the Securities Act of 1933 (the 1993 Act) or the Securities Exchange Act of 1934 (the 1934 Act) and, accordingly, the review report should contain a statement of restrictions on the use of the report to specified parties if the entity is (*a*) a public entity or (*b*) a nonpublic entity that is making or has made an offering of securities and it appears that the securities may subsequently be registered or subject to a filing with the SEC or other regulatory agency.

A practitioner[6] engaged to examine or review MD&A and report thereon should comply with the general, fieldwork, and reporting standards in section 101, *Attest Engagements*, and the specific standards set forth in this section. A practitioner engaged to perform agreed-upon procedures on MD&A should follow the guidance set forth in section 201, *Agreed-Upon Procedures Engagements*.[7]

.03 This section does not—

a. Change the auditor's responsibility in an audit of financial statements performed in accordance with generally accepted auditing standards (GAAS).

b. Apply to situations in which the practitioner is requested to provide management with recommendations to improve the MD&A rather than to provide assurance. A practitioner engaged to provide such nonattest services should refer to CS section 100, *Consulting Services: Definitions and Standards*.

c. Apply to situations in which the practitioner is engaged to provide attest services with respect to an MD&A presentation that is prepared based on criteria other than the rules and regulations adopted by the SEC. A practitioner engaged to perform an examination or a review based upon such criteria should refer to the guidance in section 101, or to section 201 if engaged to perform an agreed-upon procedures engagement.[8]

.04 The requirements for MD&A have changed periodically since the first requirement was adopted by the SEC in 1974. As of the date of issuance of this SSAE, the rules and regulations for MD&A adopted by the SEC are found in Item 303 of Regulation S-K, as interpreted by Financial Reporting Release (FRR) No. 36, *Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures* (Chapter 5 of the "Codification of Financial Reporting Policies"); Item 303 of Regulation S-B for small business issuers; and Item 9 of Form 20-F for Foreign Private Issuers.[9] Item 303 of Regulation S-K, as interpreted by FRR No. 36, Item 303 of Regulation S-B for small business issuers, and Item 9 of Form 20-F for Foreign Private Issuers, provide the relevant rules and regulations adopted by

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[6] In this section, the terms *practitioner* or *accountant* generally refer to a person engaged to perform an attest service on MD&A. The term *accountant* may also refer to a person engaged to review financial statements. The term *auditor* refers to a person engaged to audit financial statements. As this section includes certain requirements for the practitioner to have audited or performed a Statement on Auditing Standards (SAS) No. 71 review of financial statements (AU section 722, *Interim Financial Information*), the terms *auditor, practitioner*, or *accountant* may refer, in this section, to the same person.

[7] Practitioners should follow guidance in AU section 634, *Letters for Underwriters and Certain Other Requesting Parties*, when requested to perform agreed-upon procedures on MD&A and report thereon in a letter for an underwriter.

[8] The guidance in this section may be helpful when performing an engagement to provide attest services with respect to an MD&A presentation that is based on criteria other than the rules and regulations adopted by the SEC. Such other criteria would have to be suitable and available as discussed in section 101.23–.33.

[9] The SEC staff from time to time issues guidance related to the SEC's adopted requirements; for example, Staff Accounting Bulletins (SABs), Staff Legal Bulletins, and speeches. Although such guidance may provide additional information with respect to the adopted requirements for MD&A, the practitioner should not be expected to attest to assertions on compliance with such guidance. The practitioner may find it helpful to also familiarize himself or herself with material contained on the SEC's Web site http://www.sec.gov/ that provides further information with respect to the SEC's views concerning MD&A disclosures.

the SEC that meet the definition of suitable criteria in section 101.23–.32. The practitioner should consider whether the SEC has adopted additional rules and regulations with respect to MD&A subsequent to the issuance of this section.

Conditions for Engagement Performance

Examination

.05 The practitioner's objective in an engagement to examine MD&A is to express an opinion on the MD&A presentation taken as a whole by reporting whether—

a. The presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC.[10]

b. The historical financial amounts have been accurately derived, in all material respects, from the entity's financial statements.[11]

c. The underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein.[12]

.06 A practitioner may accept an engagement to examine MD&A of a public or nonpublic entity, provided the practitioner audits, in accordance with GAAS,[13] the financial statements for at least the latest period to which the MD&A presentation relates and the financial statements for the other periods covered by the MD&A presentation have been audited by the practitioner or a predecessor auditor. A base knowledge of the entity and its operations gained through an audit of the historical financial statements and knowledge about the industry and the environment is necessary to provide the practitioner with sufficient knowledge to properly evaluate the results of the procedures performed in connection with the examination.

.07 If a predecessor auditor has audited the financial statements for a prior period covered by the MD&A presentation, the practitioner (the successor auditor) should also consider whether, under the particular circumstances, he or she can acquire sufficient knowledge of the business and of the entity's accounting and financial reporting practices for such period so that he or she would be able to—

a. Identify types of potential material misstatements in MD&A and consider the likelihood of their occurrence.

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[10] The required elements as of the date of issuance of this SSAE include a discussion of the entity's financial condition, changes in financial condition, and results of operations, including a discussion of liquidity and capital resources.

[11] Whether historical financial amounts are accurately derived from the financial statements includes both amounts that are derived from the face of the financial statements (which includes the notes to the financial statements) and financial statement schedules and those that are derived from underlying records supporting elements, accounts, or items included in the financial statements.

[12] Whether the underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein requires consideration of management's interpretation of the disclosure criteria for MD&A, management's determinations as to the relevancy of information to be included, and estimates and assumptions made by management that affect reported information.

[13] Restrictions on the scope of the audit of the financial statements will not necessarily preclude the practitioner from accepting an engagement to examine MD&A. Note that the SEC will generally not accept an auditor's report that is modified for a scope limitation. The practitioner should consider the nature and magnitude of the scope limitation and the form of the auditor's report in assessing whether an examination of MD&A could be performed.

b. Perform the procedures that will provide the practitioner with a basis for expressing an opinion as to whether the MD&A presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC.

c. Perform the procedures that will provide the practitioner with a basis for expressing an opinion on the MD&A presentation with respect to whether the historical financial amounts have been accurately derived, in all material respects, from the entity's financial statements for such period.

d. Perform the procedures that will provide the practitioner with a basis for expressing an opinion as to whether the underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein.

Refer to paragraphs .99 through .101 for guidance regarding the review of the predecessor auditor's working papers.

Review

.08 The objective of a review of MD&A is to report whether any information came to the practitioner's attention to cause him or her to believe that—

a. The MD&A presentation does not include, in all material respects, the required elements of the rules and regulations adopted by the SEC.

b. The historical financial amounts included therein have not been accurately derived, in all material respects, from the entity's financial statements.

c. The underlying information, determinations, estimates, and assumptions of the entity do not provide a reasonable basis for the disclosures contained therein.

A review consists principally of applying analytical procedures and making inquiries of persons responsible for financial, accounting, and operational matters. A review ordinarily does not contemplate (*a*) tests of accounting records through inspection, observation, or confirmation, (*b*) obtaining corroborating evidential matter in response to inquiries, or (*c*) the application of certain other procedures ordinarily performed during an examination of MD&A. A review may bring to the practitioner's attention significant matters affecting the MD&A, but it does not provide assurance that the practitioner will become aware of all significant matters that would be disclosed in an examination.

.09 A practitioner may accept an engagement to review the MD&A presentation of a public entity for an annual period provided the practitioner has audited, in accordance with GAAS, the financial statements for at least the latest annual period to which the MD&A presentation relates and the financial statements for the other periods covered by the MD&A presentation have been audited by the practitioner or a predecessor auditor.[14] A base knowledge of the entity and its operations gained through an audit of the historical financial statements and knowledge about the industry and the environment is

[14] As discussed in paragraph .85*k*, a review report is not intended to be filed with the SEC as a report under the 1933 Act or the 1934 Act and, accordingly, the review report should contain a statement of restrictions on the use of the report to specified parties if the entity is (*a*) a public entity or (*b*) a nonpublic entity that is making or has made an offering of securities and it appears that the securities may subsequently be registered or subject to a filing with the SEC or other regulatory agency.

necessary to provide the practitioner with sufficient knowledge to properly evaluate the results of the procedures performed in connection with the review.

.10 If a predecessor auditor has audited the financial statements for a prior period covered by the MD&A presentation, the practitioner should also consider whether, under the particular circumstances, he or she can acquire sufficient knowledge of the business and of the entity's accounting and financial reporting practices for such period so he or she would be able to—

a. Identify types of potential material misstatements in the MD&A and consider the likelihood of their occurrence.

b. Perform the procedures that will provide the practitioner with a basis for reporting whether any information has come to the practitioner's attention to cause him or her to believe any of the following.

(1) The MD&A presentation does not include, in all material respects, the required elements of the rules and regulations adopted by the SEC.

(2) The historical financial amounts included therein have not been accurately derived, in all material respects, from the entity's financial statements for such period.

(3) The underlying information, determinations, estimates, and assumptions of the entity do not provide a reasonable basis for the disclosures contained therein.

.11 A practitioner may accept an engagement to review the MD&A presentation of a public entity for an interim period provided that both of the following conditions are met.

a. The practitioner performs either (*1*) a review of the historical financial statements for the related comparative interim periods and issues a review report thereon in accordance with AU section 722, *Interim Financial Information*, or (*2*) an audit of the interim financial statements.

b. The MD&A presentation for the most recent fiscal year has been or will be examined or reviewed by either the practitioner or a predecessor auditor.

.12 If a predecessor auditor examined or reviewed the MD&A presentation of a public entity for the most recent fiscal year, the practitioner should not accept an engagement to review the MD&A presentation for an interim period unless he or she can acquire sufficient knowledge of the business and of the entity's accounting and financial reporting practices for the interim period to perform the procedures described in paragraph .10.

.13 If a nonpublic entity chooses to prepare MD&A, the practitioner should not accept an engagement to perform a review of such MD&A for an annual period under this section unless both of the following conditions are met.

a. The annual financial statements for the periods covered by the MD&A presentation have been or will be audited and the practitioner has audited or will audit the most recent year (refer to paragraph .07 if the financial statements for prior years were audited by a predecessor auditor).

b. Management will provide a written assertion that the presentation has been prepared using the rules and regulations adopted by the SEC as the criteria. (See paragraph .02.)

.14 A practitioner may accept an engagement to review the MD&A presentation of a nonpublic entity for an interim period provided that all of the following conditions are met.

a. The practitioner performs one of the following:
   (1) A review of the historical financial statements for the related interim periods under the Statements on Standards for Accounting and Review Services (SSARSs) and issues a review report thereon
   (2) A review of the condensed interim financial information for the related interim periods under AU section 722 and issues a review report thereon, and such interim financial information is accompanied by complete annual financial statements for the most recent fiscal year that have been audited
   (3) An audit of the interim financial statements

b. The MD&A presentation for the most recent fiscal year has been or will be examined or reviewed.

c. Management will provide a written assertion stating that the presentation has been prepared using the rules and regulations adopted by the SEC as the criteria. (See paragraph .02.)

Engagement Acceptance Considerations

.15 In determining whether to accept an engagement, the practitioner should consider whether management (and others engaged by management to assist them, such as legal counsel) has the appropriate knowledge of the rules and regulations adopted by the SEC to prepare MD&A.

Responsibilities of Management

.16 Management is responsible for the preparation of the entity's MD&A pursuant to the rules and regulations adopted by the SEC. The preparation of MD&A in conformity with the rules and regulations adopted by the SEC requires management to interpret the criteria, accurately derive the historical amounts from the entity's books and records, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information.

.17 An entity should not name the practitioner in a client-prepared document as having examined or reviewed MD&A unless the MD&A presentation and related practitioner's report and the related financial statements and auditor's (or accountant's review) report are included in the document (or, in the case of a public entity, incorporated by reference to such information filed with a regulatory agency). If such a statement is made in a document that does not include (or incorporate by reference) such information, the practitioner should request that neither his or her name nor reference to the practitioner be made with respect to the MD&A information, or that such document be revised to include the required presentations and reports. If the client does not comply, the practitioner should advise the client that he or she does not consent to either the use of his or her name or the reference to the practitioner, and he or she should consider what other actions might be appropriate.[15]

[15] In considering what other actions, if any, may be appropriate in these circumstances, the practitioner may wish to consult his or her legal counsel.

Obtaining an Understanding of the SEC Rules and Regulations and Management's Methodology for the Preparation of MD&A

.18 The practitioner should obtain an understanding of the rules and regulations adopted by the SEC for MD&A. (Refer to paragraph .04.)

.19 The practitioner should inquire of management regarding the method of preparing MD&A, including matters such as the sources of the information, how the information is gathered, how management evaluates the types of factors having a material effect on financial condition (including liquidity and capital resources), results of operations, and cash flows, and whether there have been any changes in the procedures from the prior year.

Timing of Procedures

.20 Proper planning by the practitioner contributes to the effectiveness of the attest procedures in an examination or a review of MD&A. Performing some of the work in conjunction with the audit of the historical financial statements or the review of interim financial statements may permit the work to be carried out in a more efficient manner and to be completed at an earlier date. When performing an examination or a review of MD&A, the practitioner may consider the results of tests of controls, analytical procedures,[16] and substantive tests performed in a financial statement audit or analytical procedures and inquiries made in a review of financial statements or interim financial information.

Materiality

.21 The practitioner should consider the concept of materiality in planning and performing the engagement. The objective of an examination or a review is to report on the MD&A presentation taken as a whole and not on the individual amounts and disclosures contained therein. In the context of an MD&A presentation, the concept of materiality encompasses both material omissions (for example, the omission of trends, events, and uncertainties that are currently known to management that are reasonably likely to have material effects on the entity's financial condition, results of operations, liquidity, or capital resources) and material misstatements in MD&A, both of which are referred to herein as a misstatement. Assessing the significance of a misstatement of some items in MD&A may be more dependent upon qualitative than quantitative considerations. Qualitative aspects of materiality relate to the relevance and reliability of the information presented (for example, qualitative aspects of materiality are considered in assessing whether the underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures in the MD&A). Furthermore, quantitative information is often more meaningful when accompanied by qualitative disclosures. For example, quantitative information about market risk-sensitive instruments is more meaningful when accompanied by qualitative information about an entity's market risk exposures and how those exposures are managed.

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[16] AU section 329, *Analytical Procedures*, defines analytical procedures as "evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures range from simple comparisons to the use of complex models involving many relationships and elements of data." In applying analytical procedures to MD&A, the practitioner develops expectations of matters that would be discussed in MD&A by identifying and using plausible relationships that are reasonably expected to exist based on the practitioner's understanding of the client and of the industry in which the client operates, and the knowledge of relationships among the various financial elements gained through the audit of financial statements or review of interim financial information. Refer to AU section 329 for further discussion of analytical procedures.

Materiality is also a concept that is judged in light of the expected range of reasonableness of the information; therefore, users should not expect prospective information (information about events that have not yet occurred) to be as precise as historical information.

.22 In expressing an opinion, or providing the limited assurance of a review engagement, on the presentation, the practitioner should consider the omission or misstatement of an individual assertion (see paragraph .34) to be material if the magnitude of the omission or misstatement—individually or when aggregated with other omissions or misstatements—is such that a reasonable person using the MD&A presentation would be influenced by the inclusion or correction of the individual assertion. The relative rather than absolute size of an omission or misstatement may determine whether it is material in a given situation.

Inclusion of Pro Forma Financial Information

.23 Management may include pro forma financial information with respect to a business combination or other transactions in MD&A. The practitioner should consider the guidance in section 401, *Reporting on Pro Forma Financial Information*, paragraph .10, when performing procedures with respect to such information, even if management indicates in MD&A that certain information has been derived from unaudited financial statements. For example, in an examination of MD&A, the practitioner's procedures would ordinarily include obtaining an understanding of the underlying transaction or event, discussing with management their assumptions, obtaining sufficient evidence in support of the adjustments, and other procedures for the purpose of expressing an opinion on the MD&A presentation taken as a whole and not for expressing an opinion on (or providing the limited assurance of a review of) the pro forma financial information included therein under section 401.

Inclusion of External Information

.24 An entity may also include in its MD&A information external to the entity, such as the rating of its debt by certain rating agencies or comparisons with statistics from a trade association. Such external information should also be subjected to the practitioner's examination or review procedures. For example, in an examination, the practitioner might compare information concerning the statistics of a trade organization to a published source; however, the practitioner would not be expected to test the underlying support for the trade association's calculation of such statistics.

Inclusion of Forward-Looking Information

.25 An entity may include certain forward-looking disclosures in the MD&A presentation, including cautionary language concerning the achievability of the matters disclosed. Although any forward-looking disclosures that are included in the MD&A presentation should be subjected to the practitioner's examination or review, such information is subjected to testing only for the purpose of expressing an opinion that the underlying information, determinations, estimates, and assumptions provide a reasonable basis for the disclosures contained therein or providing the limited assurance of a review on the MD&A presentation taken as a whole. The practitioner may consider the guidance in section 301, *Financial Forecasts and Projections*, when performing procedures with respect to forward-looking information. The practitioner may also consider whether meaningful cautionary language has been included with the forward-looking information.

.26 Section 27A of the Securities Act of 1933 (the 1933 Act) and Section 21E of the Securities Exchange Act of 1934 (the 1934 Act) provide a safe harbor from liability in private litigation with respect to forward-looking statements that include or make reference to meaningful cautionary language. However, such sections also include exclusions from safe harbor protection in certain situations. Whether an entity's forward-looking statements and the practitioner's report thereon qualify for safe harbor protection is a legal matter.

Inclusion of Voluntary Information

.27 An entity may voluntarily include other information in the MD&A presentation that is not required by the rules and regulations adopted by the SEC for MD&A. When the entity includes in MD&A additional information required by other rules and regulations of the SEC (for example, Item 305 of Regulation S-K, *Quantitative and Qualitative Disclosures About Market Risk*), the practitioner should also consider such other rules and regulations in subjecting such information to his or her examination or review procedures.[17]

Examination Engagement

.28 To express an opinion about whether (*a*) the presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC, (*b*) the historical financial amounts have been accurately derived, in all material respects, from the entity's financial statements, and (*c*) the underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein, the practitioner seeks to obtain reasonable assurance by accumulating sufficient evidence in support of the disclosures and assumptions, thereby restricting attestation risk to an appropriately low level.

Attestation Risk

.29 In an engagement to examine MD&A, the practitioner plans and performs the examination to obtain reasonable assurance of detecting both intentional and unintentional misstatements that are material to the MD&A presentation taken as a whole. Absolute assurance is not attainable because of factors such as the need for judgment regarding the areas to be tested and the nature, timing, and extent of tests to be performed; the concept of selective testing of the data; and the inherent limitations of the controls applicable to the preparation of MD&A. The practitioner exercises professional judgment in assessing the significant determinations made by management as to the relevancy of information to be included, and the estimates and assumptions that affect reported information. As a result of these factors, in the great majority of cases, the practitioner has to rely on evidence that is persuasive rather than convincing. Also, procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion among client personnel and third parties or among management or employees of the client. Therefore, the subsequent discovery that a material misstatement exists in the MD&A does not, in and of itself, evidence (*a*) failure to obtain reasonable assurance; (*b*) inadequate planning, performance, or judgment on the part of the practitioner; (*c*) the absence of due professional care; or (*d*) a failure to comply with this section.

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[17] To the extent that the voluntary information includes forward-looking information, refer to paragraphs .25 and .26.

.30 Factors to be considered by the practitioner in planning an examination of MD&A include (*a*) the anticipated level of attestation risk related to assertions embodied in the MD&A presentation, (*b*) preliminary judgments about materiality for attest purposes, (*c*) the items within the MD&A presentation that are likely to require revision or adjustment, and (*d*) conditions that may require extension or modification of attest procedures. For purposes of an engagement to examine MD&A, the components of attestation risk are defined as follows.

a. *Inherent risk* is the susceptibility of an assertion within MD&A to a material misstatement, assuming that there are no related controls. (See paragraphs .34 through .38.)

b. *Control risk* is the risk that a material misstatement that could occur in an assertion within MD&A will not be prevented or detected on a timely basis by the entity's controls; some control risk will always exist because of the inherent limitations of any internal control.

c. *Detection risk* is the risk that the practitioner will not detect a material misstatement that exists in an assertion within MD&A.

Inherent Risk

.31 The level of inherent risk varies with the nature of the assertion. For example, the inherent risk concerning financial information included in the MD&A presentation may be low, whereas the inherent risk concerning the completeness of the disclosure of the entity's risks or liquidity may be high.

Control Risk

.32 The practitioner should assess control risk as discussed in paragraphs .53 through .57. Assessing control risk contributes to the practitioner's evaluation of the risk that material misstatement in the MD&A exists. In the process of assessing control risk (together with assessing inherent risk), the practitioner may obtain evidential matter about the risk that such misstatement may exist. The practitioner uses this evidential matter as part of the reasonable basis for his or her opinion on the MD&A presentation taken as a whole.

Detection Risk

.33 In determining an acceptable level of detection risk, the practitioner assesses inherent risk and control risk, and considers the extent to which he or she seeks to restrict attestation risk. As assessed inherent risk or control risk decreases, the acceptable level of detection risk increases. Accordingly, the practitioner may alter the nature, timing, and extent of tests performed based on the assessments of inherent risk and control risk.

Nature of Assertions

.34 Assertions are representations by management that are embodied in the MD&A presentation. They can be either explicit or implicit and can be classified according to the following broad categories:

a. Occurrence

b. Consistency with the financial statements

c. Completeness

d. Presentation and disclosure

.35 Assertions about occurrence address whether reported transactions or events have occurred during a given period. Assertions about consistency with the financial statements address whether—

a. Reported transactions, events, and explanations are consistent with the financial statements.

b. Historical financial amounts have been accurately derived from the financial statements and related records.

c. Nonfinancial data have been accurately derived from related records.

.36 Assertions about completeness address whether descriptions of transactions and events necessary to obtain an understanding of the entity's financial condition (including liquidity and capital resources), changes in financial condition, results of operations, and material commitments for capital resources are included in MD&A; and whether known events, transactions, conditions, trends, demands, commitments, or uncertainties that will result in or are reasonably likely to result in material changes to these items are appropriately described in the MD&A presentation.

.37 For example, if management asserts that the reason for an increase in revenues is a price increase in the current year, they are explicitly asserting that both an increase in revenues and a price increase have occurred in the current year, and implicitly asserting that any historical financial amounts included are consistent with the financial statements for such period. They are also implicitly asserting that the explanation for the increase in revenues is complete; that there are no other significant reasons for the increase in revenues.

.38 Assertions about presentation and disclosure address whether information included in the MD&A presentation is properly classified, described, and disclosed. For example, management asserts that any forward-looking information included in MD&A is properly classified as being based on management's present assessment and includes an appropriate description of the expected results. To further disclose the nature of such information, management may also include a statement that actual results in the future may differ materially from management's present assessment. (See paragraphs .25 and .26.)

.39 The auditor of the underlying financial statements is responsible for obtaining and evaluating evidential matter concerning the assertions embodied in the account balance or transaction class of the financial statements as discussed in AU section 326, *Evidential Matter*. Although procedures designed to achieve the practitioner's objective of forming an opinion on the MD&A presentation taken as a whole may test certain assertions embodied in the underlying financial statements, the practitioner is not expected to test the underlying financial statement assertions in an examination of MD&A. For example, the practitioner is not expected to test the completeness of revenues or the existence of inventory when testing the assertions in MD&A concerning an increase in revenues or an increase in inventory levels; assurance related to completeness of revenues or for existence of inventory would be obtained as part of the audit. The practitioner is, however, responsible for testing the completeness of the explanation for the increase in revenues or the increase in inventory levels.

Performing an Examination Engagement

.40 The practitioner should exercise (*a*) due professional care in planning, performing, and evaluating the results of his or her examination procedures and

(*b*) the proper degree of professional skepticism to obtain reasonable assurance that material misstatements will be detected.

.41 In an examination of MD&A, the practitioner should perform the following.

a. Obtain an understanding of the rules and regulations adopted by the SEC for MD&A and management's method of preparing MD&A. (See paragraphs .18 and .19.)

b. Plan the engagement. (See paragraphs .42 through .48.)

c. Consider relevant portions of the entity's internal control applicable to the preparation of MD&A. (See paragraphs .49 through .58.)

d. Obtain sufficient evidence, including testing completeness. (See paragraphs .59 through .64.)

e. Consider the effect of events subsequent to the balance-sheet date. (See paragraphs .65 and .66.)

f. Obtain written representations from management concerning its responsibility for MD&A, completeness of minutes, events subsequent to the balance-sheet date, and other matters about which the practitioner believes written representations are appropriate. (See paragraphs .110 through .112.)

g. Form an opinion about whether the MD&A presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC, whether the historical financial amounts included therein have been accurately derived, in all material respects, from the entity's financial statements, and whether the underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained in the MD&A. (See paragraph .67.)

Planning the Engagement

General Considerations

.42 Planning an engagement to examine MD&A involves developing an overall strategy for the expected scope and performance of the engagement. When developing an overall strategy for the engagement, the practitioner should consider factors such as the following:

- Matters affecting the industry in which the entity operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes
- Knowledge of the entity's internal control applicable to the preparation of MD&A obtained during the audit of the financial statements and the extent of recent changes, if any
- Matters relating to the entity's business, including its organization, operating characteristics, capital structure, and distribution methods
- The types of relevant information that management reports to external analysts (for example, press releases and presentations to lenders and rating agencies, if any, concerning past and future performance)
- How the entity analyzes actual performance compared to budgets and the types of information provided in documents submitted

to the board of directors for purposes of the entity's day-to-day operations and long-range planning

- The extent of management's knowledge of and experience with the rules and regulations adopted by the SEC for MD&A
- If the entity is a nonpublic entity, the intended use of the MD&A presentation
- Preliminary judgments about (*a*) materiality, (*b*) inherent risk at the individual assertion level, and (*c*) factors (for example, matters identified during the audit or review of the historical financial statements) relating to significant deficiencies in internal control applicable to the preparation of MD&A (See paragraph .58.)
- The fraud risk factors or other conditions identified during the audit of the most recent annual financial statements and the practitioner's response to such risk factors
- The type and extent of evidential matter supporting management's assertions and disclosures in the MD&A presentation
- The nature of complex or subjective matters potentially material to the MD&A presentation that may require special skill or knowledge and whether such matters may require using the work of a specialist to obtain sufficient evidential matter (See paragraph .47.)
- The presence of an internal audit function (See paragraph .48.)

.43 In planning an engagement when MD&A has not previously been examined, the practitioner should consider the degree to which the entity has information available for such prior periods and the continuity of the entity's personnel and their ability to respond to inquiries with respect to such periods. In addition, the practitioner should obtain an understanding of the entity's internal control in prior years applicable to the preparation of MD&A.

Consideration of Audit Results

.44 The practitioner should also consider the results of the audits of the financial statements for the periods covered by the MD&A presentation on the examination engagement, such as matters relating to the following:

- The availability and condition of the entity's records
- The nature and magnitude of audit adjustments
- Likely misstatements[18] that were not corrected in the financial statements that may affect MD&A disclosures (for example, misclassifications between financial statement line items)

.45 The practitioner should also consider the possible impact on the scope of the examination engagement of any modification or contemplated modification of the auditor's report, including matters addressed in explanatory language. For example, if the auditor has modified the auditor's report to include a going-concern uncertainty explanatory paragraph, the practitioner would consider such a matter in assessing attestation risk.

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[18] Refer to AU section 312, *Audit Risk and Materiality in Conducting on Audit*, paragraphs .34 through .40.

Multiple Components

.46 In an engagement to examine MD&A, if the entity has operations in several components (for example, locations, branches, subsidiaries, or programs), the practitioner should determine the components to which procedures should be applied. In making such a determination and in selecting the components to be tested, the practitioner should consider factors such as the following:

- The relative importance of each component to the applicable MD&A disclosure
- The degree of centralization of records
- The effectiveness of controls, particularly those that affect management's direct control over the exercise of authority delegated to others and its ability to supervise activities at various locations effectively
- The nature and extent of operations conducted at the various components
- The similarity of operations and internal control for different components

The practitioner should consider whether the audit base of the components is consistent with the components that are disclosed in MD&A. Accordingly, it may be desirable for the practitioner to coordinate the audit work with the components that will be disclosed.

Using the Work of a Specialist

.47 In some engagements to examine MD&A, the nature of complex or subjective matters potentially material to the MD&A presentation may require specialized skill or knowledge in a particular field other than accounting or auditing. For example, the entity may include information concerning plant production capacity, which would ordinarily be determined by an engineer. In such cases, the practitioner may use the work of a specialist and should consider the relevant guidance in AU section 336, *Using the Work of a Specialist*. AU section 311, *Planning and Supervision*, provides relevant guidance for situations in which a specialist employed by the practitioner's firm participates in the examination.

Internal Audit Function

.48 Another factor the practitioner should consider when planning the engagement is whether the entity has an internal audit function and the extent to which internal auditors are involved in directly testing the MD&A presentation, in monitoring the entity's internal control applicable to the preparation of MD&A, or in testing the underlying records supporting disclosures in the MD&A. A practitioner should consider the guidance in AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, when addressing the competence and objectivity of internal auditors; the nature, timing, and extent of work to be performed; and other related matters.

Consideration of Internal Control Applicable to the Preparation of MD&A

.49 The practitioner should obtain an understanding of the entity's internal control applicable to the preparation of MD&A sufficient to plan the engagement and to assess control risk. Generally, controls that are relevant to an examination pertain to the entity's objective of preparing MD&A in conformity

with the rules and regulations adopted by the SEC, and may include controls within the control environment, risk assessment, control activities, information and communication, and monitoring components.

.50 The controls relating to operations and compliance objectives may be relevant to an examination if they pertain to data the practitioner evaluates or uses in applying examination procedures. For example, controls over the gathering of information, which are different from financial statement controls, and controls relating to nonfinancial data that are included in the MD&A presentation, may be relevant to an examination engagement.

.51 In planning the examination, knowledge of such controls should be used to identify types of potential misstatement (including types of potential material omissions), to consider factors that affect the risk of material misstatement and to design appropriate tests.

.52 A practitioner generally obtains an understanding of the design of the entity's internal control applicable to the preparation of MD&A by making inquiries of appropriate management, supervisory, and staff personnel; by inspection of the entity's documents; and by observation of the entity's relevant activities, including controls over matters discussed, nonfinancial data included, and management evaluation of the reasonableness of information included. The nature and extent of procedures a practitioner performs vary from entity to entity and are influenced by factors such as the entity's complexity, the length of time that the entity has prepared MD&A pursuant to the rules and regulations adopted by the SEC, the practitioner's knowledge of the entity's controls obtained in audits and previous professional engagements, and judgments about materiality.

.53 After obtaining an understanding of the entity's internal control applicable to the preparation of MD&A, the practitioner assesses control risk for the assertions embodied in the MD&A presentation. (Refer to paragraphs .34 through .39.) The practitioner may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's controls) because the practitioner believes controls are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient. Alternatively, the practitioner may obtain evidential matter about the effectiveness of both the design and operation of a control that supports a lower assessed level of control risk. Such evidential matter may be obtained from tests of controls planned and performed concurrently with obtaining the understanding of the internal control or from procedures performed to obtain the understanding that were not specifically planned as tests of controls.

.54 After obtaining the understanding and assessing control risk, the practitioner may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the practitioner considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient.

.55 When seeking to assess control risk below the maximum for controls over financial and nonfinancial data, the practitioner should perform tests of controls to obtain evidence to support the assessed level of control risk. For example, the practitioner may perform tests of controls directed toward the effectiveness of the design or operation of internal control over the accumulation of the number of units sold for a manufacturing company, average interest rates earned and paid for a financial institution, or average net sales per square foot for a retail entity.

.56 The practitioner uses the knowledge provided by the understanding of internal control applicable to the preparation of MD&A and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for the MD&A assertions.

.57 The practitioner should document the understanding of the internal control components obtained to plan the examination and the assessment of control risk. The form and extent of this documentation is influenced by the size and complexity of the entity, as well as the nature of the entity's controls applicable to the preparation of MD&A.

.58 During the course of an engagement to examine MD&A, the practitioner may become aware of significant deficiencies in the design or operation of internal control applicable to the preparation of MD&A that could adversely affect the entity's ability to prepare MD&A in accordance with the rules and regulations adopted by the SEC. The practitioner should consider the implications of such control deficiencies on his or her ability to rely on management's explanations and on comparisons to summary accounting records. A practitioner's responsibility to communicate these control deficiencies in an examination of MD&A is similar to the auditor's responsibility described in AU section 325, *Communication of Internal Control Related Matters Noted in an Audit*, and AU section 380, *Communication With Audit Committees*.

Obtaining Sufficient Evidence

.59 The practitioner should apply procedures to obtain reasonable assurance of detecting material misstatements. In an audit of historical financial statements, the practitioner will have applied audit procedures to some of the information included in the MD&A. However, because the objective of those audit procedures is to have a reasonable basis for expressing an opinion on the financial statements taken as a whole rather than on the MD&A, certain additional examination procedures should be performed as discussed in paragraphs .60 through .64. Determining these procedures and evaluating the sufficiency of the evidence obtained are matters of professional judgment.

.60 The practitioner ordinarily should apply the following procedures.

a. Read the MD&A and compare the content for consistency with the audited financial statements; compare financial amounts to the audited financial statements or related accounting records and analyses; recompute the increases, decreases, and percentages disclosed.

b. Compare nonfinancial amounts to the audited financial statements, if applicable, or to other records. (Refer to paragraphs .62 through .64.)

c. Consider whether the explanations in MD&A are consistent with the information obtained during the audit; investigate further those explanations that cannot be substantiated by information in the audit working papers through inquiry (including inquiry of officers and other executives having responsibility for operational areas) and inspection of client records.

d. Examine internally generated documents (for example, variance analyses, sales analyses, wage cost analyses, sales or service pricing sheets, and business plans or programs) and externally generated documents (for example, correspondence, contracts, or loan agreements) in support of the existence, occurrence, or expected

occurrence of events, transactions, conditions, trends, demands, commitments, and uncertainties disclosed in the MD&A.

e. Obtain available prospective financial information (for example, budgets; sales forecasts; forecasts of labor, overhead, and materials costs; capital expenditure requests; and financial forecasts and projections) and compare such information to forward-looking MD&A disclosures. Inquire of management as to the procedures used to prepare the prospective financial information. Evaluate whether the underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the MD&A disclosures of events, transactions, conditions, trends, demands, commitments, or uncertainties.[19]

f. Consider obtaining available prospective financial information relating to prior periods and comparing actual results with forecasted and projected amounts.

g. Make inquiries of officers and other executives having responsibility for operational areas (such as sales, marketing, and production) and financial and accounting matters, as to their plans and expectations for the future that could affect the entity's liquidity and capital resources.

h. Consider obtaining external information concerning industry trends, inflation, and changing prices and comparing the related MD&A disclosures to such information.

i. Compare the information in MD&A with the rules and regulations adopted by the SEC and consider whether the presentation includes the required elements of such rules and regulations.

j. Read the minutes of meetings to date of the board of directors and other significant committees to identify matters that may affect MD&A; consider whether such matters are appropriately addressed in MD&A.

k. Inquire of officers as to the entity's prior experience with the SEC and the extent of comments received upon review of documents by the SEC; read correspondence between the entity and the SEC with respect to such review, if any.

l. Obtain public communications (for example, press releases and quarterly reports) and the related supporting documentation dealing with historical and future results; consider whether MD&A is consistent with such communications.

m. Consider obtaining other types of publicly available information (for example, analyst reports and news articles); compare the MD&A presentation with such information.

Testing Completeness

.61 The practitioner should design procedures to test the presentation for completeness, including tests of the completeness of explanations that relate to historical disclosures as discussed in paragraphs .36 and .37. The practitioner should also consider whether the MD&A discloses matters that could significantly impact future financial condition and results of operations of the entity by considering information that he or she obtained through the following:

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[19] Refer to paragraph .26 for a discussion concerning the safe harbor rules for forward-looking statements.

a. Audit of the financial statements

b. Inquiries of the entity's officers and other executives directed to current events, conditions, economic changes, commitments and uncertainties, within both the entity and its industry

c. Other information obtained through procedures such as those listed in paragraphs .60, .65, and .66

As discussed in paragraph .31, the inherent risk concerning the completeness of disclosures may be high; if it is, the practitioner may extend the procedures (for example, by making additional inquiries of management or by examining additional internally generated documents).

Nonfinancial Data

.62 Management may include nonfinancial data (such as units produced; the number of units sold, locations, or customers; plant utilization; or square footage) in the MD&A. The practitioner should consider whether the definitions used by management for such nonfinancial data are reasonable for the particular disclosure in the MD&A and whether there are suitable criteria (for example, industry standards with respect to square footage for retail operations), as discussed in section 101.23–.32.

.63 In some situations, the nonfinancial data or the controls over the nonfinancial data may have been tested by the practitioner in conjunction with the financial statement audit; however, the practitioner's consideration of the nature of the procedures to apply to nonfinancial data in an examination of MD&A is based on the concept of materiality with respect to the MD&A presentation. The practitioner should consider whether industry standards exist for the nonfinancial data or whether there are different methods of measurement that may be used, and, if such methods could result in significantly different results, whether the method of measurement selected by management is reasonable and consistent between periods covered by the MD&A presentation. For example, the number of customers reported by management could vary depending on whether management defines a customer as a subsidiary or "ship to" location of a company rather than the company itself.

.64 In testing nonfinancial data included in the MD&A, the practitioner may seek to assess control risk below the maximum for controls over such nonfinancial data, as discussed in paragraph .55. The practitioner weighs the increase in effort of the examination associated with the additional tests of controls that is necessary to obtain evidential matter against the resulting decrease in examination effort associated with the reduced substantive tests. For those nonfinancial assertions for which the practitioner performs additional tests of controls, the practitioner determines the assessed level of control risk that the results of those tests will support. This assessed level of control risk is used in determining the appropriate detection risk to accept for those nonfinancial assertions and, accordingly, in determining the nature, timing, and extent of substantive tests for such assertions.

Consideration of the Effect of Events Subsequent to the Balance-Sheet Date

.65 As there is an expectation by the SEC that MD&A considers events through a date at or near the filing date,[20] the practitioner should consider

[20] A registration statement under the 1933 Act speaks as of its effective date.

information about events[21] that comes to his or her attention after the end of the period addressed by MD&A and prior to the issuance of his or her report that may have a material effect on the entity's financial condition (including liquidity and capital resources), changes in financial condition, results of operations, and material commitments for capital resources. Events or matters that should be disclosed in MD&A include those that—[22]

- Are reasonably expected to have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.
- Are reasonably likely to result in the entity's liquidity increasing or decreasing in any material way.
- Will have a material effect on the entity's capital resources.
- Would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.

The practitioner should consider whether events identified during the examination of the MD&A presentation or the audit of the related financial statements require adjustment to or disclosure in the MD&A presentation. When MD&A will be included or incorporated by reference in a 1933 Act document that is filed with the SEC, the practitioner's procedures should extend up to the filing date or as close to it as is reasonable and practicable in the circumstances.[23] If a public entity's MD&A presentation is to be included only in a filing under the 1934 Act (for example, Forms 10-K or 10-KSB), the practitioner's responsibility to consider subsequent events does not extend beyond the date of the report on MD&A. Paragraphs .94 through .98 provide guidance when the practitioner is engaged subsequent to the filing of the MD&A presentation.

.66 In an examination of MD&A, the practitioner's fieldwork ordinarily extends beyond the date of the auditor's report on the related financial statements.[24] Accordingly, the practitioner generally should—

a. Read available minutes of meetings of stockholders, the board of directors, and other appropriate committees; as to meetings for which minutes are not available, inquire about matters dealt with at such meetings.

b. Read the latest available interim financial statements for periods subsequent to the date of the auditor's report, compare them with the financial statements for the periods covered by the MD&A, and inquire of and discuss with officers and other executives

[21] Such events are only referred to as *subsequent events* in relation to an MD&A presentation if they occur after the MD&A presentation has been issued. The annual MD&A presentation ordinarily would not be updated for subsequent events if an MD&A presentation for a subsequent interim period has been issued or the event has been reported through a filing on Form 8-K.

[22] The practitioner should refer to the rules and regulations adopted by the SEC for other examples of events that should be disclosed.

[23] Additionally, if the practitioner's report on MD&A is included or incorporated by reference in a 1933 Act document, the practitioner should extend his or her procedures with respect to subsequent events from the date of his or her report on MD&A up to the effective date or as close thereto as is reasonable and practicable in the circumstances.

[24] Undertaking an engagement to examine MD&A does not extend the auditor's responsibility to update the subsequent events review procedures for the financial statements beyond the date of the auditor's report. However, see AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. Also, see AU section 711, *Filings Under Federal Securities Statutes*, as to an auditor's responsibility when his or her report is included in a registration statement filed under the 1933 Act.

having responsibility for operational, financial, and accounting matters (limited where appropriate to major locations) matters such as the following:

- Whether interim financial statements have been prepared on the same basis as the audited financial statements
- Whether there were any significant changes in the entity's operations, liquidity, or capital resources in the subsequent period
- The current status of items in the financial statements for which the MD&A has been prepared that were accounted for on the basis of tentative, preliminary, or inconclusive data
- Whether any unusual adjustments were made during the period from the balance-sheet date to the date of inquiry

c. Make inquiries of members of senior management as to the current status of matters concerning litigation, claims, and assessments identified during the audit of the financial statements and of any new matters or unfavorable developments. Consider obtaining updated legal letters from legal counsel.[25]

d. Consider whether there have been any changes in economic conditions or in the industry that could have a significant effect on the entity.

e. Obtain written representations from appropriate officials as to whether any events occurred subsequent to the latest balance-sheet date that would require disclosure in the MD&A. (See paragraphs .110 through .112.)

f. Make such additional inquiries or perform such other procedures as considered necessary and appropriate to address questions that arise in carrying out the foregoing procedures, inquiries, and discussions.

Forming an Opinion

.67 The practitioner should consider the concept of materiality discussed in paragraphs .21 and .22, and the impact of any modification of the auditor's report on the historical financial statements in forming an opinion on the examination of MD&A, including the practitioner's ability to evaluate the results of inquiries and other procedures.

Reporting

.68 In order for the practitioner to issue a report on an examination of MD&A, the financial statements for the periods covered by the MD&A presentation and the related auditor's report(s) should accompany the MD&A presentation (or, with respect to a public entity, be incorporated in the document containing the MD&A by reference to information filed with a regulatory agency). In addition, if the entity is a nonpublic entity, one of the following conditions should be met.

a. A statement should be included in the body of the MD&A presentation that it has been prepared using the rules and regulations adopted by the SEC.

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[25] See AU section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, for guidance concerning obtaining legal letters.

b. A separate written assertion should accompany the MD&A presentation or such assertion should be included in a representation letter obtained from the entity.

.69 The practitioner's report on an examination of MD&A should include the following:

a. A title that includes the word *independent*

b. An identification of the MD&A presentation, including the period covered

c. A statement that management is responsible for the preparation of the MD&A pursuant to the rules and regulations adopted by the SEC, and a statement that the practitioner's responsibility is to express an opinion on the presentation based on his or her examination

d. A reference to the auditor's report on the related financial statements, and if the report was other than a standard report, the substantive reasons therefor

e. A statement that the examination was conducted in accordance with attestation standards established by the AICPA and a description of the scope of an examination of MD&A

f. A statement that the practitioner believes the examination provides a reasonable basis for his or her opinion

g. A paragraph stating that—

(1) The preparation of MD&A requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information

(2) Actual results in the future may differ materially from management's present assessment of information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties

h. If the entity is a nonpublic entity, a statement that, although the entity is not subject to the rules and regulations of the SEC, the MD&A presentation is intended to be a presentation in accordance with the rules and regulations adopted by the SEC

i. The practitioner's opinion on whether—

(1) The presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC

(2) The historical financial amounts have been accurately derived, in all material respects, from the entity's financial statements

(3) The underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein

j. The manual or printed signature of the practitioner's firm

k. The date of the examination report

Appendix A [paragraph .114], "Examination Reports," includes a standard examination report. (See Example 1.)

Dating

.70 The practitioner's report on the examination of MD&A should be dated as of the completion of the practitioner's examination procedures. That date should not precede the date of the auditor's report on the latest historical financial statements covered by the MD&A.

Report Modifications

.71 The practitioner should modify the standard report described in paragraph .69, if any of the following conditions exist.

- The presentation excludes a material required element under the rules and regulations adopted by the SEC. (See paragraph .72.)
- The historical financial amounts have not been accurately derived, in all material respects, from the entity's financial statements. (See paragraph .72.)
- The underlying information, determinations, estimates, and assumptions used by management do not provide the entity with a reasonable basis for the disclosure in the MD&A. (See paragraph .72.)
- There is a restriction on the scope of the engagement. (See paragraph .73.)
- The practitioner decides to refer to the report of another practitioner as the basis in part for his or her report. (See paragraph .74.)
- The practitioner is engaged to examine the MD&A presentation after it has been filed with the SEC or other regulatory agency. (See paragraphs .94 through .98.)

.72 The practitioner should express a qualified or an adverse opinion if (*a*) the MD&A presentation excludes a material required element, (*b*) historical financial amounts have not been accurately derived in all material respects, or (*c*) the underlying information, determinations, estimates, and assumptions of the entity do not provide a reasonable basis for the disclosures; for example, if there is a lack of consistency between management's method of measuring nonfinancial data between periods covered by the MD&A presentation. The basis for such opinion should be stated in the practitioner's report. Appendix A [paragraph .114] includes several examples of such modifications. (See Example 2.) Also refer to paragraph .107 for required communications with the audit committee.

.73 If the practitioner is unable to perform the procedures he or she considers necessary in the circumstances, the practitioner should modify the report or withdraw from the engagement. If the practitioner modifies the report, he or she should describe the limitation on the scope of the examination in an explanatory paragraph and qualify his or her opinion, or disclaim an opinion. However, limitations on the ability of the practitioner to perform necessary procedures could also arise because of the lack of adequate support for a significant representation in the MD&A. That circumstance may result in a conclusion that the unsupported representation constitutes a material misstatement of fact and, accordingly, the practitioner may qualify his or her opinion or express an adverse opinion, as described in paragraph .72.

Reference to Report of Another Practitioner

.74 If another practitioner examined the MD&A presentation of a component (refer to paragraph .46), the practitioner may decide to make reference to such report of the other practitioner as a basis for his or her opinion on the consolidated MD&A presentation. The practitioner should disclose this fact in the introductory paragraph of the report and should refer to the report of the other practitioner in expressing an opinion on the consolidated MD&A presentation. These references indicate a division of responsibility for performance of the examination. Appendix A [paragraph .114] provides an example of a report for such a situation. (See Example 3.) Refer to paragraph .105 for guidance when the other practitioner does not issue a report.

Emphasis of a Matter

.75 In a number of circumstances, the practitioner may wish to emphasize a matter regarding the MD&A presentation. For example, he or she may wish to emphasize that the entity has included information beyond the required elements of the rules and regulations adopted by the SEC. Such explanatory comments should be presented in a separate paragraph of the practitioner's report.

Review Engagement

.76 The objective of a review engagement, including a review of MD&A for an interim period, is to accumulate sufficient evidence to provide the practitioner with a basis for reporting whether any information came to the practitioner's attention to cause him or her to believe that (*a*) the MD&A presentation does not include, in all material respects, the required elements of the rules and regulations adopted by the SEC, (*b*) the historical financial amounts included therein have not been accurately derived, in all material respects, from the entity's financial statements, or (*c*) the underlying information, determinations, estimates, and assumptions of the entity do not provide a reasonable basis for the disclosures contained therein. MD&A for an interim period may be a freestanding presentation or it may be combined with the MD&A presentation for the most recent fiscal year. Procedures for conducting a review of MD&A generally are limited to inquiries and analytical procedures, rather than also including search and verification procedures, concerning factors that have a material effect on financial condition, including liquidity and capital resources, results of operations, and cash flows. In a review engagement, the practitioner should—

a. Obtain an understanding of the rules and regulations adopted by the SEC for MD&A and management's method of preparing MD&A. (See paragraphs .18 and .19.)

b. Plan the engagement. (See paragraph .77.)

c. Consider relevant portions of the entity's internal control applicable to the preparation of the MD&A. (See paragraph .78.)

d. Apply analytical procedures and make inquiries of management and others. (See paragraphs .79 and .80.)

e. Consider the effect of events subsequent to the balance-sheet date. The practitioner's consideration of such events in a review of MD&A is similar to the practitioner's consideration in an examination. (See paragraphs .65 and .66.)

f. Obtain written representations from management concerning its responsibility for MD&A, completeness of minutes, events subsequent to the balance-sheet date, and other matters about which

the practitioner believes written representations are appropriate. (See paragraph .110.)

g. Form a conclusion as to whether any information came to the practitioner's attention that causes him or her to believe any of the following.

(1) The MD&A presentation does not include, in all material respects, the required elements of the rules and regulations adopted by the SEC.

(2) The historical financial amounts included therein have not been accurately derived, in all material respects, from the entity's financial statements.

(3) The underlying information, determinations, estimates, and assumptions of the entity do not provide a reasonable basis for the disclosures contained therein.

Planning the Engagement

.77 Planning an engagement to review MD&A involves developing an overall strategy for the analytical procedures and inquiries to be performed. When developing an overall strategy for the review engagement, the practitioner should consider factors such as the following:

- Matters affecting the industry in which the entity operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes
- Matters relating to the entity's business, including its organization, operating characteristics, capital structure, and distribution methods
- The types of relevant information that management reports to external analysts (for example, press releases or presentations to lenders and rating agencies concerning past and future performance)
- The extent of management's knowledge of and experience with the rules and regulations adopted by the SEC for MD&A
- If the entity is a nonpublic entity, the intended use of the MD&A presentation
- Matters identified during the audit or review of the historical financial statements relating to MD&A reporting, including knowledge of the entity's internal control applicable to the preparation of MD&A and the extent of recent changes, if any
- Matters identified during prior engagements to examine or review MD&A
- Preliminary judgments about materiality
- The nature of complex or subjective matters potentially material to the MD&A that may require special skill or knowledge
- The presence of an internal audit function and the extent to which internal auditors are involved in directly testing the MD&A presentation or underlying records

Consideration of Internal Control Applicable to the Preparation of MD&A

.78 To perform a review of MD&A, the practitioner needs to have sufficient knowledge of the entity's internal control applicable to the preparation of MD&A to—

- Identify types of potential misstatements in MD&A, including types of material omissions, and consider the likelihood of their occurrence.
- Select the inquiries and analytical procedures that will provide a basis for reporting whether any information causes the practitioner to believe the following.
  - — The MD&A presentation does not include, in all material respects, the required elements of the rules and regulations adopted by the SEC, or the historical financial amounts included therein have not been accurately derived, in all material respects, from the entity's financial statements.
  - — The underlying information, determinations, estimates, and assumptions of the entity do not provide a reasonable basis for the disclosures contained therein.

Application of Analytical Procedures and Inquiries

.79 The practitioner ordinarily would not obtain corroborating evidential matter of management's responses to the practitioner's inquiries in performing a review of MD&A. The practitioner should, however, consider the consistency of management's responses in light of the results of other inquiries and the application of analytical procedures. The practitioner ordinarily should apply the following analytical procedures and inquiries.

a. Read the MD&A presentation and compare the content for consistency with the audited financial statements (or reviewed interim financial information if MD&A includes interim information); compare financial amounts to the audited or reviewed financial statements or related accounting records and analyses; recompute the increases, decreases, and percentages disclosed.

b. Compare nonfinancial amounts to the audited (or reviewed) financial statements, if applicable, or to other records. (Refer to paragraph .80.)

c. Consider whether the explanations in MD&A are consistent with the information obtained during the audit or the review of interim financial information; make further inquiries of officers and other executives having responsibility for operational areas as necessary.

d. Obtain available prospective financial information (for example, budgets; sales forecasts; forecasts of labor, overhead, and materials costs; capital expenditure requests; and financial forecasts and projections) and compare such information to forward-looking MD&A disclosures. Inquire of management as to the procedures used to prepare the prospective financial information. Consider whether information came to the practitioner's attention that causes him or her to believe that the underlying information, determinations, estimates, and assumptions of the entity do not

provide a reasonable basis for the disclosures of trends, demands, commitments, events, or uncertainties.[26]

e. Make inquiries of officers and other executives having responsibility for operational areas (such as sales, marketing, and production) and financial and accounting matters, as to any plans and expectations for the future that could affect the entity's liquidity and capital resources.

f. Compare the information in MD&A with the rules and regulations adopted by the SEC and consider whether the presentation includes the required elements of such rules and regulations.

g. Read the minutes of meetings to date of the board of directors and other significant committees to identify actions that may affect MD&A; consider whether such matters are appropriately addressed in the MD&A presentation.

h. Inquire of officers as to the entity's prior experience with the SEC and the extent of comments received upon review of documents by the SEC; read correspondence between the entity and the SEC with respect to such review, if any.

i. Inquire of management regarding the nature of public communications (for example, press releases and quarterly reports) dealing with historical and future results and consider whether the MD&A presentation is consistent with such communications.

.80 If nonfinancial data are included in the MD&A presentation, the practitioner should inquire as to the nature of the records from which such information was derived and observe the existence of such records, but need not perform other tests of such records beyond analytical procedures and inquiries of individuals responsible for maintaining them. The practitioner should consider whether such nonfinancial data are relevant to users of the MD&A presentation and whether such data are clearly defined in the MD&A presentation. The practitioner should make inquiries regarding whether the definition of the nonfinancial data was consistently applied during the periods reported.

.81 However, if the practitioner becomes aware that the presentation may be incomplete or contain inaccuracies, or is otherwise unsatisfactory, the practitioner should perform the additional procedures he or she deems necessary to achieve the limited assurance contemplated by a review engagement.

Reporting

.82 In order for the practitioner to issue a report on a review of MD&A for an annual period, the financial statements for the periods covered by the MD&A presentation and the related auditor's report(s) should accompany the MD&A presentation (or with respect to a public entity be incorporated in the document containing the MD&A by reference to information filed with a regulatory agency).

.83 If the MD&A presentation relates to an interim period and the entity is a public entity, the financial statements for the interim periods covered by the MD&A presentation and the related accountant's review report(s) should accompany the MD&A presentation, or be incorporated in the document containing the MD&A by reference to information filed with a regulatory agency. The comparative financial statements for the most recent annual period and

[26] Refer to paragraph .26 for a discussion concerning the safe harbor rules for forward-looking statements.

the related MD&A should accompany the MD&A presentation for the interim period, or be incorporated by reference to information filed with a regulatory agency. Generally, the requirement for inclusion of the annual financial statements and related MD&A is satisfied by a public entity that has met its reporting responsibility for filing its annual financial statements and MD&A in its annual report on Form 10-K.

.84 If the MD&A presentation relates to an interim period and the entity is a nonpublic entity, the following documents should accompany the interim MD&A presentation in order for the practitioner to issue a review report:

a. The MD&A presentation for the most recent fiscal year and related accountant's examination or review report(s)

b. The financial statements for the periods covered by the respective MD&A presentations (most recent fiscal year and interim periods and the related auditor's report(s) and accountant's review report(s))

In addition, one of the following conditions should be met.

- A statement should be included in the body of the MD&A presentation that it has been prepared using the rules and regulations adopted by the SEC.
- A separate written assertion should accompany the MD&A presentation or such assertion should be included in a representation letter obtained from the entity.

.85 The practitioner's report on a review of MD&A should include the following:

a. A title that includes the word *independent*

b. An identification of the MD&A presentation, including the period covered

c. A statement that management is responsible for the preparation of the MD&A pursuant to the rules and regulations adopted by the SEC

d. A reference to the auditor's report on the related financial statements, and, if the report was other than a standard report, the substantive reasons therefor

e. A statement that the review was conducted in accordance with attestation standards established by the AICPA

f. A description of the procedures for a review of MD&A

g. A statement that a review of MD&A is substantially less in scope than an examination, the objective of which is an expression of opinion regarding the MD&A presentation, and accordingly, no such opinion is expressed

h. A paragraph stating that—

(1) The preparation of MD&A requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information

(2) Actual results in the future may differ materially from management's present assessment of information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected

sources of liquidity and capital resources, operating trends, commitments, and uncertainties

i. If the entity is a nonpublic entity, a statement that although the entity is not subject to the rules and regulations of the SEC, the MD&A presentation is intended to be a presentation in accordance with the rules and regulations adopted by the SEC

j. A statement about whether any information came to the practitioner's attention that caused him or her to believe that—

(1) The MD&A presentation does not include, in all material respects, the required elements of the rules and regulations adopted by the SEC

(2) The historical financial amounts included therein have not been accurately derived, in all material respects, from the entity's financial statements

(3) The underlying information, determinations, estimates, and assumptions of the entity do not provide a reasonable basis for the disclosures contained therein

k. If the entity is a public entity as defined in paragraph .02, or a nonpublic entity that is making or has made an offering of securities and it appears that the securities may subsequently be registered or subject to a filing with the SEC or other regulatory agency (for example, certain offerings of securities under Rule 144A of the 1933 Act that purport to conform to Regulation S-K), a statement of restrictions on the use of the report to specified parties, because it is not intended to be filed with the SEC as a report under the 1933 Act or the 1934 Act.

l. The manual or printed signature of the practitioner's firm

m. The date of the review report

Appendix B [paragraph .115], "Review Reports," provides examples of a standard review report for an annual and interim period.

Dating

.86 The practitioner's report on the review of MD&A should be dated as of the completion of the practitioner's review procedures. That date should not precede the date of the accountant's report on the latest historical financial statements covered by the MD&A.

Report Modifications

.87 The practitioner should modify the standard review report described in paragraph .86 if any of the following conditions exist.

- The presentation excludes a material required element of the rules and regulations adopted by the SEC. (See paragraph .89.)
- The historical financial amounts have not been accurately derived, in all material respects, from the entity's financial statements. (See paragraph .89.)
- The underlying information, determinations, estimates, and assumptions used by management do not provide the entity with a reasonable basis for the disclosures in the MD&A. (See paragraph .89.)

- The practitioner decides to refer to the report of another practitioner as the basis, in part, for his or her report. (See paragraph .90.)
- The practitioner is engaged to review the MD&A presentation after it has been filed with the SEC or other regulatory agency. (See paragraphs .94 through .98.)

.88 When the practitioner is unable to perform the inquiry and analytical procedures he or she considers necessary to achieve the limited assurance provided by a review, or the client does not provide the practitioner with a representation letter, the review will be incomplete. A review that is incomplete is not an adequate basis for issuing a review report. If the practitioner is unable to complete a review because of a scope limitation, the practitioner should consider the implications of that limitation with respect to possible misstatements of the MD&A presentation. In those circumstances, the practitioner should also refer to paragraphs .107 through .109 for guidance concerning communications with the audit committee.

.89 If the practitioner becomes aware that the MD&A is materially misstated, the practitioner should modify the review report to describe the nature of the misstatement. Appendix B [paragraph .115] contains an example of such a modification of the accountant's report. (See Example 3.)

.90 If another practitioner reviewed or examined the MD&A for a material component, the practitioner may decide to make reference to such report of the other practitioner in reporting on the consolidated MD&A presentation. Such reference indicates a division of responsibility for performance of the review.

Emphasis of a Matter

.91 In some circumstances, the practitioner may wish to emphasize a matter regarding the MD&A presentation. For example, he or she may wish to emphasize that the entity has included information beyond the required elements of the rules and regulations adopted by the SEC. Such explanatory comments should be presented in a separate paragraph of the practitioner's report.

Combined Examination and Review Report on MD&A

.92 A practitioner may be engaged both to examine an MD&A presentation as of the most recent fiscal year-end and to review a separate MD&A presentation for a subsequent interim period. If the examination and review are completed at the same time, a combined report may be issued. Appendix C [paragraph .116], "Combined Reports," contains an example of a combined report on an examination of an annual MD&A presentation and the review of a separate MD&A presentation for an interim period. (See Example 1.)

.93 If an entity prepares a combined MD&A presentation for annual and interim periods in which there is a discussion of liquidity and capital resources only as of the most recent interim period but not as of the most recent annual period, the practitioner is limited to performing the highest level of service that is provided with respect to the historical financial statements for any of the periods covered by the MD&A presentation. For example, if the annual financial statements have been audited and the interim financial statements have been reviewed, the practitioner may be engaged to perform a review of the combined MD&A presentation. Appendix C [paragraph .116] contains an example of a review report on a combined MD&A presentation for annual and interim periods. (See Example 2.)

When Practitioner Is Engaged Subsequent to the Filing of MD&A

.94 Management's responsibility for updating an MD&A presentation for events occurring subsequent to the issuance of MD&A depends on whether the entity is a public or nonpublic entity. A public entity is required to report significant subsequent events in a Form 8-K or Form 10-Q, or in a registration statement; therefore, a public company would ordinarily not modify its MD&A presentation once it is filed with the SEC (or other regulatory agency).

.95 Therefore, if the practitioner is engaged to examine (or review) an MD&A presentation of a public entity that has already been filed with the SEC (or other regulatory agency), the practitioner should consider whether material subsequent events are appropriately disclosed in a Form 8-K or 10-Q, or a registration statement that includes or incorporates by reference such MD&A presentation. Refer to paragraphs .65 and .66 for guidance concerning consideration of events up to the filing date when the practitioner's report on MD&A will be included (or incorporated by reference) in a 1933 Act document filed with the SEC that will require a consent.

.96 If subsequent events of a public entity are appropriately disclosed in a Form 8-K or 10-Q, or in a registration statement, or if there have been no material subsequent events, the practitioner should add the following paragraph to his or her examination or review report following the opinion or concluding paragraph, respectively.

The accompanying Management's Discussion and Analysis does not consider events that have occurred subsequent to Month XX, 20X6, the date as of which it was filed with the Securities and Exchange Commission.

.97 If there has been a material subsequent event that has not been disclosed in a manner described in paragraph .95 and if the practitioner determines that it is appropriate to issue a report even though the MD&A presentation has not been updated for such material subsequent event (for example, because the filing of the Form 10-Q that will disclose such events has not yet occurred), the practitioner should express a qualified or an adverse opinion (or appropriately modify the review report) on the MD&A presentation. As discussed in paragraph .107, if such material subsequent event is not appropriately disclosed, the practitioner should evaluate (*a*) whether to resign from the engagement related to the MD&A presentation and (*b*) whether to remain as the entity's auditor or stand for re-election to audit the entity's financial statements.

.98 Because a nonpublic entity is not subject to the filing requirements of the SEC, an MD&A presentation of a nonpublic entity should be updated for material subsequent events through the date of the practitioner's report.

When a Predecessor Auditor Has Audited Prior Period Financial Statements

.99 If a predecessor auditor has audited the financial statements for a prior period covered by the MD&A, the need by the practitioner reporting on the MD&A for an understanding of the business and the entity's accounting and financial reporting practices for such prior period, as discussed in paragraph .07, is not diminished and the practitioner should apply the appropriate procedures. In applying the appropriate procedures, the practitioner may consider reviewing the predecessor auditor's working papers with respect to audits of

financial statements and examinations or reviews of MD&A presentations for such prior periods.

.100 Information that may be obtained from the audit or attest working papers of the predecessor auditor will not provide a sufficient basis in itself for the practitioner to express an opinion with respect to the MD&A disclosures for such prior periods. If the practitioner has audited the current year, the results of such audit may be considered in planning and performing the examination of MD&A and may provide evidential matter that is useful in performing the examination, including with respect to matters disclosed for prior periods. For example, an increase in salaries expense may be the result of an acquisition in the last half of the prior year. Auditing procedures applied to payroll expense in the current year that validate the increase as a result of the acquisition may provide evidential matter with respect to the increase in salaries expense in the prior year attributed to the acquisition.

.101 In addition to the procedures described in paragraphs .49 through .66, the practitioner will need to make inquiries of the predecessor auditor and management as to audit adjustments proposed by the predecessor auditor that were not recorded in the financial statements.

Communications Between Predecessor and Successor Auditors

.102 If the practitioner is appointed as the successor auditor, he or she follows the guidance in AU section 315, *Communications Between Predecessor and Successor Auditors*, in considering whether or not to accept the engagement. If, at the time of the appointment as auditor, the practitioner is also being engaged to examine or review MD&A, the practitioner should also make specific inquiries of the predecessor auditor regarding MD&A.

.103 The practitioner's examination may be facilitated by (*a*) making specific inquiries of the predecessor regarding matters that the successor believes may affect the conduct of the examination (or review), such as areas that required an inordinate amount of time or problems that arose from the condition of the records, and (*b*) if the predecessor previously examined or reviewed MD&A, reviewing the predecessor's working papers for the predecessor's examination or review engagement.

.104 If, subsequent to his or her engagement to audit the financial statements, the practitioner is requested to examine MD&A, the practitioner should request the client to authorize the predecessor auditor to allow a review of the predecessor's audit working papers related to the financial statement periods included in the MD&A presentation. Although the practitioner may previously have had access to the predecessor auditor's working papers in connection with the successor's audit of the financial statements, ordinarily the predecessor auditor should permit the practitioner to review those audit working papers relating to matters that are disclosed or that would likely be disclosed in MD&A.

Another Auditor Audits a Significant Part of the Financial Statements

.105 When another auditor or auditors audit a significant part of the financial statements, the practitioner[27] may request that such other auditor or

[27] The practitioner serving as principal auditor is presumed to have an audit base for purposes of examining or reviewing the consolidated MD&A presentation.

auditors perform procedures with respect to the MD&A or the practitioner may perform the procedures directly with respect to such component(s).[28] Unless the other auditor issues an examination or review report on a separate MD&A presentation of such component(s) (see paragraph .74), the principal practitioner should not make reference to the work of the other practitioner on MD&A in his or her report on MD&A.[29] Accordingly, if the practitioner has requested such other auditor to perform procedures, the principal practitioner should perform those procedures that he or she considers necessary to take responsibility for the work of the other auditor. Such procedures may include one or more of the following:

a. Visiting the other auditor and discussing the procedures followed and the results thereof.

b. Reviewing the working papers of the other auditor with respect to the component.

c. Participating in discussions with the component's management regarding matters that may affect the preparation of MD&A.

d. Making supplemental tests with respect to such component.

The determination of the extent of the procedures to be applied by the principal practitioner rests with the principal practitioner alone in the exercise of his or her professional judgment and in no way constitutes a reflection on the adequacy of the other auditor's work. Because the principal practitioner in this case assumes responsibility for his or her opinion on the MD&A presentation without making reference to the procedures performed by the other auditor, the practitioner's judgment should govern as to the extent of procedures to be undertaken.

Responsibility for Other Information in Documents Containing MD&A

.106 A client may publish annual reports containing MD&A and other documents to which the practitioner, at the client's request, devotes attention. See section 101.91–.94 for pertinent guidance in these circumstances. See Appendix D [paragraph .117], "Comparison of Activities Performed Under SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*, Versus a Review or an Examination Attest Engagement." The guidance in AU section 711, *Filings Under Federal Securities Statutes*, is pertinent when the practitioner's report on MD&A is included in a registration statement, proxy statement, or periodic report filed under the federal securities statutes.

Communications With the Audit Committee

.107 If the practitioner concludes that the MD&A presentation contains material inconsistencies with other information included in the document containing the MD&A presentation or with the historical financial statements,[30]

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[28] The practitioner should consider whether he or she has sufficient industry expertise with respect to a subsidiary audited by another auditor to take sole responsibility for the consolidated MD&A presentation.

[29] This does not preclude the practitioner from referring to the other auditor's report on the financial statements in his or her report on MD&A.

material omissions, or material misstatements of fact, and management refuses to take corrective action, the practitioner should inform the audit committee or others with equivalent authority and responsibility. If the MD&A is not revised, the practitioner should evaluate (*a*) whether to resign from the engagement related to the MD&A, and (*b*) whether to remain as the entity's auditor or stand for re-election to audit the entity's financial statements. The practitioner may wish to consult with his or her attorney when making these evaluations.

.108 If the practitioner is engaged after the MD&A presentation has been filed with the SEC (or other regulatory agency), and becomes aware that such MD&A presentation on file with the SEC (or other regulatory agency) has not been revised for a matter for which the practitioner has or would qualify his or her opinion, the practitioner should discuss such matter with the audit committee and request that the MD&A presentation be revised. If the audit committee fails to take appropriate action, the practitioner should consider whether to resign as the independent auditor of the company. The practitioner may consider the guidance concerning communication with the audit committee and other considerations in AU section 317, *Illegal Acts by Clients,* paragraphs .17, .22, and .23).

.109 If, as a result of performing an examination or a review of MD&A, the practitioner has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is generally appropriate even if the matter might be considered clearly inconsequential. If the matter relates to the audited financial statements, the practitioner should consider the guidance in AU section 316, *Consideration of Fraud in a Financial Statement Audit*, concerning communication responsibilities, and the effect on the auditor's report on the financial statements.

Obtaining Written Representations

.110 In an examination or a review engagement, the practitioner should obtain written representations from management.[31] The specific written representations obtained by the practitioner will depend on the circumstances of the engagement and the nature of the MD&A presentation. Specific representations should relate to the following matters:

a. Management's acknowledgment of its responsibility for the preparation of MD&A and management's assertion that the MD&A presentation has been prepared in accordance with the rules and regulations adopted by the SEC for MD&A[32]

b. A statement that the historical financial amounts included in MD&A have been accurately derived from the entity's financial statements

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[30] See AU section 550, *Information in Documents Containing Audited Financial Statements*, for guidance on the impact of material inconsistencies or material misstatements of fact on the auditor's report on the related historical financial statements.

[31] AU section 333, *Management Representations*, paragraph .09, provides guidance on the date as of which management should sign such a representation letter and on which member(s) of management should sign it. AU section 711.10 provides guidance concerning obtaining updated representations from management in connection with accountant's reports included or incorporated by reference in filings under the 1933 Act. (See paragraph .65.)

[32] Management should specify the SEC rules (for example, Item 303 of Regulation S-K, Item 303 of Regulation S-B, or Item 9 of Form 20-F). For nonpublic entities, the practitioner also obtains a written assertion that the presentation has been prepared using the rules and regulations adopted by the SEC. (See paragraph .02.)

c. Management's belief that the underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained in the MD&A

d. A statement that management has made available all significant documentation related to compliance with SEC rules and regulations for MD&A

e. Completeness and availability of all minutes of meetings of stockholders, directors, and committees of directors

f. For a public entity, whether any communications from the SEC were received concerning noncompliance with or deficiencies in MD&A reporting practices

g. Whether any events occurred subsequent to the latest balance-sheet date that would require disclosure in the MD&A

h. If forward-looking information is included, a statement that—

- The forward-looking information is based on management's best estimate of expected events and operations, and is consistent with budgets, forecasts, or operating plans prepared for such periods
- The accounting principles expected to be used for the forward-looking information are consistent with the principles used in preparing the historical financial statements
- Management has provided the latest version of such budgets, forecasts, or operating plans, and has informed the practitioner of any anticipated changes or modifications to such information that could affect the disclosures contained in the MD&A presentation

i. If voluntary information is included that is subject to the rules and regulations adopted by the SEC (for example, information required by Item 305, *Quantitative and Qualitative Disclosures About Market Risk*), a statement that such voluntary information has been prepared in accordance with the related rules and regulations adopted by the SEC for such information

j. If pro forma information is included, a statement that—

- Management is responsible for the assumptions used in determining the pro forma adjustments
- Management believes that the assumptions provide a reasonable basis for presenting all the significant effects directly attributable to the transaction or event, that the related pro forma adjustments give appropriate effect to those assumptions, and that the pro forma column reflects the proper application of those adjustments to the historical financial statements
- Management believes that the significant effects directly attributable to the transaction or event are appropriately disclosed in the pro forma financial information

.111 In an examination, management's refusal to furnish written representations constitutes a limitation on the scope of the engagement sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause a practitioner to disclaim an opinion or withdraw from the examination engagement.

However, based on the nature of the representations not obtained or the circumstances of the refusal, the practitioner may conclude that a qualified opinion is appropriate in an examination engagement. In a review engagement, management's refusal to furnish written representations constitutes a limitation of the scope of the engagement sufficient to require withdrawal from the review engagement. Further, the practitioner should consider the effects of the refusal on his or her ability to rely on other management representations.

.112 If the practitioner is precluded from performing procedures he or she considers necessary in the circumstances with respect to a matter that is material to the MD&A presentation, even though management has given representations concerning the matter, there is a limitation on the scope of the engagement, and the practitioner should qualify his or her opinion or disclaim an opinion in an examination engagement, or withdraw from a review engagement.

Effective Date

.113 This section is effective when management's discussion and analysis is for a period ending on or after June 1, 2001. Early application is permitted.

.114

Appendix A

Examination Reports

Example 1: Standard Examination Report

1. The following is an illustration of a standard examination report.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined XYZ Company's Management's Discussion and Analysis taken as a whole, included [*incorporated by reference*] in the Company's [*insert description of registration statement or document*]. Management is responsible for the preparation of the Company's Management's Discussion and Analysis pursuant to the rules and regulations adopted by the Securities and Exchange Commission. Our responsibility is to express an opinion on the presentation based on our examination. We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company as of December 31, 20X5 and 20X4, and for each of the years in the three-year period ended December 31, 20X5, and in our report dated [*Month*] XX, 20X6, we expressed an unqualified opinion on those financial statements.[33]

[*Scope paragraph*]

Our examination of Management's Discussion and Analysis was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting the historical amounts and disclosures in the presentation. An examination also includes assessing the significant determinations made by management as to the relevancy of information to be included and the estimates and assumptions that affect reported information. We believe that our examination provides a reasonable basis for our opinion.

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[33] If prior financial statements were audited by other auditors, this sentence would be replaced by the following.

> We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company as of and for the year ended December 31, 20X5, and in our report dated [*Month*] XX, 20X6, we expressed an unqualified opinion on those financial statements. The financial statements of XYZ Company as of December 31, 20X4, and for each of the years in the two-year period then ended were audited by other auditors, whose report dated [*Month*] XX, 20X5, expressed an unqualified opinion on those financial statements. If the practitioner's opinion on the financial statements is based on the report of other auditors, this sentence would be replaced by the following:
>
> We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company as of December 31, 20X5 and 20X4, and for each of the years in the three-year period ended December 31, 20X5, and in our report dated [*Month*] XX, 20X6, we expressed an unqualified opinion on those financial statements based on our audits and the report of other auditors.
>
> Refer to Example 3 if the practitioner's opinion on MD&A is based on the report of another practitioner on a component of the entity.

[*Explanatory paragraph*][34]

The preparation of Management's Discussion and Analysis requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information. Management's Discussion and Analysis includes information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

[*Opinion paragraph*]

In our opinion, the Company's presentation of Management's Discussion and Analysis includes, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission; the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's financial statements; and the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

[*Signature*]

[*Date*]

Example 2: Modifications to Examination Report for a Qualified Opinion

2. An example of a modification of an examination report for a qualified opinion due to a material omission described in paragraph .72 follows.

[*Additional explanatory paragraph preceding the opinion paragraph*]

Based on information furnished to us by management, we believe that the Company has excluded a discussion of the significant capital outlay required for its plans to expand into the telecommunications industry and the possible effects on the Company's financial condition, liquidity, and capital resources.

[*Opinion paragraph*]

In our opinion, except for the omission of the matter described in the preceding paragraph, the Company's presentation of Management's Discussion and Analysis includes, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission; the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's financial statements; and the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

3. An example of a modification of an examination report for a qualified opinion when overly subjective assertions are included in MD&A follows.

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[34] The following sentence should be added to the beginning of the explanatory paragraph if the entity is a nonpublic entity, as discussed in paragraph .69*h*:

Although XYZ Company is not subject to the rules and regulations of the Securities and Exchange Commission, the accompanying Management's Discussion and Analysis is intended to be a presentation in accordance with the rules and regulations adopted by the Securities and Exchange Commission.

[*Additional explanatory paragraph preceding the opinion paragraph*]

Based on information furnished to us by management, we believe that the underlying information, determinations, estimates, and assumptions used by management do not provide the Company with a reasonable basis for the disclosure concerning [*describe*] in the Company's Management's Discussion and Analysis.

[*Opinion paragraph*]

In our opinion, except for the disclosure regarding [*describe*] discussed in the preceding paragraph, the Company's presentation of Management's Discussion and Analysis includes, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission; the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's financial statements; and the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

Example 3: Examination Report With Reference to the Report of Another Practitioner

4. The following is an illustration of an examination report indicating a division of responsibility with another practitioner, who has examined a separate MD&A presentation of a wholly-owned subsidiary, when the practitioner reporting is serving as the principal auditor of the related consolidated financial statements.

Independent Accountant's Report

[*Introductory paragraphs*]

We have examined XYZ Company's Management's Discussion and Analysis taken as a whole, included [*incorporated by reference*] in the Company's [*insert description of registration statement or document*]. Management is responsible for the preparation of the Company's Management's Discussion and Analysis pursuant to the rules and regulations adopted by the Securities and Exchange Commission. Our responsibility is to express an opinion on the presentation based on our examination. We did not examine Management's Discussion and Analysis of ABC Corporation, a wholly-owned subsidiary, included in ABC Corporation's [*insert description of registration statement or document*]. Such Management's Discussion and Analysis was examined by other accountants, whose report has been furnished to us, and our opinion, insofar as it relates to information included for ABC Corporation, is based solely on the report of the other accountants.

We have audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated financial statements of XYZ Company as of December 31, 20X5 and 20X4, and for each of the years in the three-year period ended December 31, 20X5, and in our report dated [*Month*] XX, 20X6, we expressed an unqualified opinion on those financial statements based on our audits and the report of other auditors.

[*Scope paragraph*]

Our examination of Management's Discussion and Analysis was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting the historical amounts and disclosures in the presentation. An examination also includes assessing the significant determinations

made by management as to the relevancy of information to be included and the estimates and assumptions that affect reported information. We believe that our examination and the report of other accountants provide a reasonable basis for our opinion.

[*Explanatory paragraph*][35]

The preparation of Management's Discussion and Analysis requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information. Management's Discussion and Analysis includes information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

[*Opinion paragraph*]

In our opinion, based on our examination and the report of other accountants, the Company's presentation of Management's Discussion and Analysis included [*incorporated by reference*] in the Company's [*insert description of registration statement or document*] includes, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission; the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's financial statements; and the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

[*Signature*]

[*Date*]

[35] The following sentence should be added to the beginning of the explanatory paragraph if the entity is a nonpublic entity, as discussed in paragraph .69*h*.

Although XYZ Company is not subject to the rules and regulations of the Securities and Exchange Commission, the accompanying Management's Discussion and Analysis is intended to be a presentation in accordance with the rules and regulations adopted by the Securities and Exchange Commission.

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Appendix B

Review Reports

Example 1: Standard Review Report on an Annual MD&A Presentation

1. The following is an illustration of a standard review report on an annual MD&A presentation.

Independent Accountant's Report

[*Introductory paragraph*]

We have reviewed XYZ Company's Management's Discussion and Analysis taken as a whole, included [*incorporated by reference*] in the Company's [*insert description of registration statement or document*]. Management is responsible for the preparation of the Company's Management's Discussion and Analysis pursuant to the rules and regulations adopted by the Securities and Exchange Commission. We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company as of December 31, 20X5 and 20X4, and for each of the years in the three-year period ended December 31, 20X5, and in our report dated [*Month*] XX, 20X6, we expressed an unqualified opinion on those financial statements.

[*Scope paragraph*]

We conducted our review of Management's Discussion and Analysis in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review of Management's Discussion and Analysis consists principally of applying analytical procedures and making inquiries of persons responsible for financial, accounting, and operational matters. It is substantially less in scope than an examination, the objective of which is the expression of an opinion on the presentation. Accordingly, we do not express such an opinion.

[*Explanatory paragraph*][36]

The preparation of Management's Discussion and Analysis requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information. Management's Discussion and Analysis includes information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

[*Concluding paragraph*]

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[36] The following sentence should be added to the beginning of the explanatory paragraph if the entity is a nonpublic entity, as discussed in paragraph .85*i*.

Although XYZ Company is not subject to the rules and regulations of the Securities and Exchange Commission, the accompanying Management's Discussion and Analysis is intended to be a presentation in accordance with the rules and regulations adopted by the Securities and Exchange Commission.

Based on our review, nothing came to our attention that caused us to believe that the Company's presentation of Management's Discussion and Analysis does not include, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission, that the historical financial amounts included therein have not been accurately derived, in all material respects, from the Company's financial statements, or that the underlying information, determinations, estimates and assumptions of the Company do not provide a reasonable basis for the disclosures contained therein.

[*Restricted use paragraph*][37]

This report is intended solely for the information and use of [*list or refer to specified parties*] and is not intended to be and should not be used by anyone other than the specified parties.

[*Signature*]

[*Date*]

Example 2: Standard Review Report on an Interim MD&A Presentation

2. The following is an illustration of a standard review report on an MD&A presentation for an interim period.

Independent Accountant's Report

[*Introductory paragraph*]

We have reviewed XYZ Company's Management's Discussion and Analysis taken as a whole included in the Company's [*insert description of registration statement or document*]. Management is responsible for the preparation of the Company's Management's Discussion and Analysis pursuant to the rules and regulations adopted by the Securities and Exchange Commission. We have reviewed, in accordance with standards established by the American Institute of Certified Public Accountants, the interim financial information of XYZ Company as of June 30, 20X6 and 20X5, and for the three-month and six-month periods then ended, and have issued our report thereon dated July XX, 20X6.

[*Scope paragraph*]

We conducted our review of Management's Discussion and Analysis in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review of Management's Discussion and Analysis consists principally of applying analytical procedures and making inquiries of persons responsible for financial, accounting, and operational matters. It is substantially less in scope than an examination, the objective of which is the expression of an opinion on the presentation. Accordingly, we do not express such an opinion.

[*Explanatory paragraph*][38]

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[37] This paragraph may be omitted for certain nonpublic entities. (Refer to paragraph .85*k*.)

[38] The following sentence should be added to the beginning of the explanatory paragraph if the entity is a nonpublic entity, as discussed in paragraph .85*i*.

> Although XYZ Company is not subject to the rules and regulations of the Securities and Exchange Commission, the accompanying Management's Discussion and Analysis is intended to be a presentation in accordance with the rules and regulations adopted by the Securities and Exchange Commission.

The preparation of Management's Discussion and Analysis requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information. Management's Discussion and Analysis includes information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

[*Concluding paragraph*]

Based on our review, nothing came to our attention that caused us to believe that the Company's presentation of Management's Discussion and Analysis does not include, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission, that the historical financial amounts included therein have not been accurately derived, in all material respects, from the Company's financial statements, or that the underlying information, determinations, estimates, and assumptions of the Company do not provide a reasonable basis for the disclosures contained therein.

[*Restricted use paragraph*][39]

This report is intended solely for the information and use of [*list or refer to specified parties*] and is not intended to be and should not be used by anyone other than the specified parties.

[*Signature*]

[*Date*]

Example 3: Modification to Review Report for a Material Misstatement

3. An example of a modification of the accountant's report when MD&A is materially misstated, as discussed in paragraph .89, follows.

[*Additional explanatory paragraph preceding the concluding paragraph*]

Based on information furnished to us by management, we believe that the Company has excluded a discussion of the significant capital outlay required for its plans to expand into the telecommunications industry and the possible effects on the Company's financial condition, liquidity, and capital resources.

[*Concluding paragraph*]

Based on our review, with the exception of the matter described in the preceding paragraph, nothing came to our attention that caused us to believe that the Company's presentation of Management's Discussion and Analysis does not include, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission, that the historical financial amounts included therein have not been accurately derived, in all material respects, from the Company's financial statements, or that the underlying information, determinations, estimates and assumptions of the Company do not provide a reasonable basis for the disclosures contained therein.

[39] This paragraph may be omitted for certain nonpublic entities. (Refer to paragraph .85*k*.)

.116

Appendix C

Combined Reports

Example 1: Combined Examination and Review Report on MD&A

1. An example of a combined report on an examination of an annual MD&A presentation and the review of MD&A for an interim period discussed in paragraph .92 follows.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined XYZ Company's Management's Discussion and Analysis taken as a whole for the three-year period ended December 31, 20X5, included [*incorporated by reference*] in the Company's [*insert description of registration statement or document*]. Management is responsible for the preparation of the Company's Management's Discussion and Analysis pursuant to the rules and regulations adopted by the Securities and Exchange Commission. Our responsibility is to express an opinion on the annual presentation based on our examination. We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company as of December 31, 20X5 and 20X4, and for each of the years in the three-year period ended December 31, 19X5, and in our report dated [*Month*] XX, 20X6, we expressed an unqualified opinion on those financial statements.

[*Scope paragraph*]

Our examination of Management's Discussion and Analysis was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting the historical amounts and disclosures in the presentation. An examination also includes assessing the significant determinations made by management as to the relevancy of information to be included and the estimates and assumptions that affect reported information. We believe that our examination provides a reasonable basis for our opinion.

[*Explanatory paragraph*][40]

The preparation of Management's Discussion and Analysis requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information. Management's Discussion and Analysis includes information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

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[40] The following sentence should be added to the beginning of the explanatory paragraph if the entity is a nonpublic entity, as discussed in paragraph .69*h*.

Although XYZ Company is not subject to the rules and regulations of the Securities and Exchange Commission, the accompanying Management's Discussion and Analysis is intended to be a presentation in accordance with the rules and regulations adopted by the Securities and Exchange Commission.

[*Opinion paragraph*]

In our opinion, the Company's presentation of Management's Discussion and Analysis for the three-year period ended December 31, 20X5, includes, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission; the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's financial statements; and the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

[*Paragraphs on interims*]

We have also reviewed XYZ Company's Management's Discussion and Analysis taken as a whole for the six-month period ended June 30, 20X6 included [*incorporated by reference*] in the Company's [*insert description of registration statement or document*]. We have reviewed, in accordance with standards established by the American Institute of Certified Public Accountants, the interim financial information of XYZ Company as of June 30, 20X6 and 20X5, and for the six-month periods then ended, and have issued our report thereon dated July XX, 20X6.

We conducted our review of Management's Discussion and Analysis in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review of Management's Discussion and Analysis consists principally of applying analytical procedures and making inquiries of persons responsible for financial, accounting, and operational matters. It is substantially less in scope than an examination, the objective of which is the expression of an opinion on the presentation. Accordingly, we do not express such an opinion.

Based on our review, nothing came to our attention that caused us to believe that the Company's presentation of Management's Discussion and Analysis for the six-month period ended June 30, 20X6, does not include, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission, that the historical financial amounts included therein have not been accurately derived, in all material respects, from the Company's unaudited interim financial statements, or that the underlying information, determinations, estimates, and assumptions of the Company do not provide a reasonable basis for the disclosures contained therein.

[*Restricted use paragraph*][41]

This report is intended solely for the information and use of [*list or refer to specified parties*] and is not intended to be and should not be used by anyone other than the specified parties.

[*Signature*]

[*Date*]

Example 2: Review Report on a Combined Annual and Interim MD&A Presentation

2. An example of a review report on a combined MD&A presentation for annual and interim periods follows.

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[41] This paragraph may be omitted for certain nonpublic entities. (Refer to paragraph .85*k*.)

Independent Accountant's Report

[*Introductory paragraph*]

We have reviewed XYZ Company's Management's Discussion and Analysis taken as a whole included [*incorporated by reference*] in the Company's [*insert description of registration statement or document*]. Management is responsible for the preparation of the Company's Management's Discussion and Analysis pursuant to the rules and regulations adopted by the Securities and Exchange Commission. We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company as of December 31, 20X5 and 20X4, and for each of the years in the three-year period ended December 31, 20X5, and in our report dated [*Month*] XX, 20X6, we expressed an unqualified opinion on those financial statements. We have reviewed, in accordance with standards established by the American Institute of Certified Public Accountants, the interim financial information of XYZ Company as of June 30, 20X6 and 20X5, and for the six-month periods then ended, and have issued our report thereon dated July XX, 20X6.

[*Scope paragraph*]

We conducted our review of Management's Discussion and Analysis in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review of Management's Discussion and Analysis consists principally of applying analytical procedures and making inquiries of persons responsible for financial, accounting, and operational matters. It is substantially less in scope than an examination, the objective of which is the expression of an opinion on the presentation. Accordingly, we do not express such an opinion.

[*Explanatory paragraph*][42]

The preparation of Management's Discussion and Analysis requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information. Management's Discussion and Analysis includes information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

[*Concluding paragraph*]

Based on our review, nothing came to our attention that caused us to believe that the Company's presentation of Management's Discussion and Analysis does not include, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange Commission, that the historical financial amounts included therein have not been accurately derived, in all material respects, from the Company's financial statements, or that the underlying information, determinations, estimates, and assumptions of the Company do not provide a reasonable basis for the disclosures contained therein.

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[42] The following sentence should be added to the beginning of the explanatory paragraph if the entity is a nonpublic entity, as discussed in paragraph .69*h*.

Although XYZ Company is not subject to the rules and regulations of the Securities and Exchange Commission, the accompanying Management's Discussion and Analysis is intended to be a presentation in accordance with the rules and regulations adopted by the Securities and Exchange Commission.

[*Restricted use paragraph*][43]

This report is intended solely for the information and use of [*list or refer to specified parties*] and is not intended to be and should not be used by anyone other than the specified parties.

[*Signature*]

[*Date*]

[43] This paragraph may be omitted for certain nonpublic entities. (Refer to paragraph .85*k*.)

.117

Appendix D

Comparison of Activities Performed Under SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* [AU section 550], Versus a Review or an Examination Attest Engagement*

Activities	*SAS No. 8*	*Review*	*Examination*
Obtain an understanding of SEC rules and regulations and management's methodology for the preparation of Management's Discussion and Analysis (MD&A).	Not applicable (N/A)—Auditor is only required to read the information in the MD&A and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.	Obtain an understanding of the rules and regulations adopted by the SEC for MD&A. Inquire of management regarding the method of preparing MD&A.	Same as for a review.
Plan the engagement.	N/A	Develop an overall strategy for the analytical procedures and inquiries to be performed to provide negative assurance.	Develop an overall strategy for the expected scope and performance of the engagement to obtain reasonable assurance to express an opinion.
Consider internal control.	N/A	Consider relevant portions of the entity's internal control applicable to the preparation of MD&A to identify the types of potential misstatements and to select the inquiries and analytical procedures; no testing of controls would be performed.	Obtain an understanding of internal control applicable to the preparation of MD&A sufficient to plan the engagement and to assess control risk; controls may be tested by performing inquiries of client personnel, inspection of documents, and observation of relevant activities.

(continued)

* Refer to AU section 550, *Other Information in Documents Containing Audited Financial Statements*.

Activities	*SAS No. 8*	*Review*	*Examination*
Test assertions.	N/A	Apply the following analytical procedures and make inquiries of management and others; no corroborating evidential matter is obtained:	Apply the following analytical and corroborative procedures to obtain reasonable assurance of detecting material misstatements:
		• Read the MD&A and compare the content for consistency with the financial statements; compare financial amounts to the financial statements or related accounting records and analyses; recompute increases, decreases and percentages disclosed.	• Read the MD&A and compare the content for consistency with the financial statements; compare financial amounts to the financial statements or related accounting records and analyses; recompute increases, decreases and percentages disclosed.
		• Compare nonfinancial amounts to the financial statements or other records.	• Compare nonfinancial amounts to the financial statements or other records; perform tests on other records based on the concept of materiality.
		• Consider whether MD&A explanations are consistent with information obtained during the audit or review of financial statements; make further inquiries, as necessary. (Note: Such additional inquiries may result in a decision to perform other procedures or detail tests.)	• Consider whether explanations are consistent with the information obtained during the audit of financial statements; investigate further explanations that cannot be substantiated by information in the audit working papers through inquiry and inspection of client records.

Activities	*SAS No. 8*	*Review*	*Examination*
Test assertions. (*continued*)		• Compare information in MD&A with the rules and regulations adopted by the SEC.	• Examine internally and externally generated documents in support of the existence, occurrence, or expected occurrence of events, transactions, conditions, trends, demands, commitments, and uncertainties disclosed in MD&A.
		• Obtain and read available prospective financial information; inquire of management as to the procedures used to prepare such information; consider whether information came to the practitioner's attention that causes him or her to believe that the underlying information, determinations, estimates, and assumptions do not provide a reasonable basis for the MD&A disclosures.	• Compare information in MD&A with the rules and regulations adopted by the SEC.
		• Obtain public communications and minutes of meetings for comparison with disclosures in MD&A.	• Obtain and read available prospective financial information; inquire of management as to the procedures used to prepare such information; evaluate whether the underlying information, determinations, estimates, and assumptions provide a reasonable basis for the MD&A disclosures.

(continued)

Activities	*SAS No. 8*	*Review*	*Examination*
		• Make inquiries of the officers or executives with responsibility for operational areas and financial and accounting matters as to their plans and expectations for the future.	
		• Inquire as to prior experience with the SEC and the extent of comments received; read correspondence.	• Obtain public communications and minutes of meetings; consider obtaining other types of publicly available information for comparison with the disclosures in MD&A.
		• Consider whether there are any additional matters that should be disclosed in the MD&A based on the results of the preceding procedures and knowledge obtained during the audit or review of the financial statements.	• Make inquiries of the officers or executives with responsibility for operational areas and financial and accounting matters as to their plans and expectations for the future.
			• Inquire as to prior experience with the SEC and the extent of comments received; read correspondence.
			• Test completeness by considering the results of the preceding procedures and knowledge obtained during the audit of the financial statements, and whether such matters are appropriately disclosed in the MD&A; extend procedures if the inherent risk relating to completeness of disclosures is high.

Activities	*SAS No. 8*	*Review*	*Examination*
Consider the effect of events subsequent to the balance-sheet date.	N/A	Yes	Yes
Obtain written representations from management.	N/A	Yes	Yes
Form a conclusion and report.	The auditor has no reporting responsibility with respect to MD&A unless the auditor concludes that there is a material inconsistency in the MD&A that has not been eliminated. In such a situation, the auditor may add an explanatory paragraph concerning the inconsistency to the auditor's report on the financial statements or withhold the use of the report in the document.	Form a conclusion based on the results of the preceding procedures and report in the form of negative assurance.	Form an opinion based on the results of the preceding procedures and report conclusion by expressing an opinion.
	If, while reading the MD&A, the auditor becomes aware of information that is believed to be a material misstatement of fact, the auditor should discuss such matter with the client.		

AT TOPICAL INDEX

References are to AT section and paragraph numbers.
Section numbers in the 9000 series refer to interpretations.

A

B

C

D

E

K

L

M

N

O

P

Q

R

S

T

CODE OF PROFESSIONAL CONDUCT

ET Section 100
INDEPENDENCE, INTEGRITY, AND OBJECTIVITY

TABLE OF CONTENTS

ET Section 101

Independence

.01 Rule 101—Independence A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council.

[As adopted January 12, 1988.]

Interpretations under Rule 101—Independence

In performing an attest engagement, a member should consult the rules of his or her state board of accountancy, his or her state CPA society, the U.S. Securities and Exchange Commission (SEC) if the member's report will be filed with the SEC, the U.S. Department of Labor (DOL) if the member's report will be filed with the DOL, the AICPA SEC Practice Section (SECPS) if the member's firm is a member of the SECPS, the General Accounting Office (GAO) if law, regulation, agreement, policy or contract requires the member's report to be filed under GAO regulations, and any organization that issues or enforces standards of independence that would apply to the member's engagement. Such organizations may have independence requirements or rulings that differ from (e.g., may be more restrictive than) those of the AICPA.

.02 101-1—Interpretation of Rule 101. Independence shall be considered to be impaired if:

A. During the **period of the professional engagement**[*] a **covered member**

1. Had or was committed to acquire any direct or material indirect financial interest in the **client**.
2. Was a trustee of any trust or executor or administrator of any estate if such trust or estate had or was committed to acquire any direct or material indirect financial interest in the client and
   (i) The covered member (individually or with others) had the authority to make investment decisions for the trust or estate; or
   (ii) The trust or estate owned or was committed to acquire more than 10 percent of the client's outstanding equity securities or other ownership interests; or
   (iii) The value of the trust's or estate's holdings in the client exceeded 10 percent of the total assets of the trust or estate.

[*] Terms shown in **boldface** type upon first usage in this interpretation are defined in ET section 92, *Definitions*. [Footnote added, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

3. Had a **joint closely held investment** that was material to the covered member.

4. Except as specifically permitted in interpretation 101-5 [ET section 101.07], had any **loan** to or from the client, any officer or director of the client, or any individual owning 10 percent or more of the client's outstanding equity securities or other ownership interests.

B. During the period of the professional engagement, a **partner** or professional employee of the **firm**, his or her **immediate family**, or any group of such persons acting together owned more than 5 percent of a client's outstanding equity securities or other ownership interests.

C. During the period covered by the **financial statements** or during the period of the professional engagement, a firm, or partner or professional employee of the firm was simultaneously associated with the client as a(n)

1. Director, officer, or employee, or in any capacity equivalent to that of a member of management;

2. Promoter, underwriter, or voting trustee; or

3. Trustee for any pension or profit-sharing trust of the client.

Transition Period for Certain Business and Employment Relationships

A business or employment relationship with a client that impairs independence under interpretation 101-1.C [ET section 101.02], and that existed as of November 2001, will not be deemed to impair independence provided such relationship was permitted under rule 101 [ET section 101.01], and its interpretations and rulings as of November 2001, and the individual severed that relationship on or before May 31, 2002.

Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated With a Client

An individual who was formerly (i) employed by a client or (ii) associated with a client as a(n) officer, director, promoter, underwriter, voting trustee, or trustee for a pension or profit-sharing trust of the client would impair his or her firm's independence if the individual—

1. Participated on the **attest engagement team** or was an **individual in a position to influence the attest engagement** for the client when the **attest engagement** covers any period that includes his or her former employment or association with that client; or

2. Was otherwise a covered member with respect to the client unless the individual first dissociates from the client by—

(*a*) Terminating any relationships with the client described in interpretation 101-1.C [ET section 101.02];

(*b*) Disposing of any direct or material indirect financial interest in the client;

(*c*) Collecting or repaying any loans to or from the client, except for loans specifically permitted or grandfathered under interpretation 101-5 [ET section 101.07];

(*d*) Ceasing to participate[1] in all employee benefit plans sponsored by the client, unless the client is legally required to allow the individual to participate in the plan (for example, COBRA) and the individual pays 100 percent of the cost of participation on a current basis; and

(*e*) Liquidating or transferring all vested benefits in the client's defined benefit plans, defined contribution plans, deferred compensation plans, and other similar arrangements at the earliest date permitted under the plan. However, liquidation or transfer is not required if a penalty[2] significant to the benefits is imposed upon liquidation or transfer.

Application of the Independence Rules to a Covered Member's Immediate Family

Except as stated in the following paragraph, a covered member's immediate family is subject to rule 101 [ET section 101.01], and its interpretations and rulings.

The exceptions are that independence would not be considered to be impaired solely as a result of the following:

1. An individual in a covered member's immediate family was employed by the client in a position other than a **key position**.
2. In connection with his or her employment, an individual in the immediate family of one of the following covered members participated in a retirement, savings, compensation, or similar plan that is a client, is sponsored by a client, or that invests in a client (provided such plan is normally offered to all employees in similar positions):
    a. A partner or **manager** who provides ten or more hours of non-attest services to the client; or
    b. Any partner in the **office** in which the lead attest engagement partner primarily practices in connection with the attest engagement.

For purposes of determining materiality under rule 101 [ET section 101.01] the financial interests of the covered member and his or her immediate family should be aggregated.

Application of the Independence Rules to Close Relatives

Independence would be considered to be impaired if—

1. An individual participating on the attest engagement team has a **close relative** who had
    a. A key position with the client, or
    b. A financial interest in the client that
        (i) Was material to the close relative and of which the individual has knowledge; or

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[1] See Ethics Ruling No. 107, "Participation in Health and Welfare Plan of Client" [ET section 191.214–.215], for instances in which participation was the result of permitted employment of the individual's spouse or spousal equivalent.

[2] A penalty includes an early withdrawal penalty levied under the tax law but excludes other income taxes that would be owed or market losses that may be incurred as a result of the liquidation or transfer.

(ii) Enabled the close relative to exercise **significant influence** over the client.

2. An individual in a position to influence the attest engagement or any partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement has a close relative who had

a. A key position with the client; or

b. A financial interest in the client that

(i) Was material to the close relative and of which the individual or partner has knowledge; and

(ii) Enabled the close relative to exercise significant influence over the client.

Grandfathered Employment Relationships

Employment relationships of a covered member's immediate family and close relatives with an existing attest client that impair independence under this interpretation and that existed as of November 2001, will not be deemed to impair independence provided such relationships were permitted under preexisting requirements of rule 101 [ET section 101.01], and its interpretations and rulings.

Other Considerations

It is impossible to enumerate all circumstances in which the appearance of independence might be questioned. Members should consider whether personal and business relationships between the member and the client or an individual associated with the client would lead a reasonable person aware of all the relevant facts to conclude that there is an unacceptable threat to the member's and the firm's independence.

[Paragraph added by adoption of the Code of Professional Conduct on January 12, 1988. Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, November 1991, effective January 1, 1992, with earlier application encouraged, by the Professional Ethics Executive Committee. Revised, effective February 28, 1998, by the Professional Ethics Executive Committee. Revised, November 2001, effective May 31, 2002, with earlier application encouraged, by the Professional Ethics Executive Committee. Revised, effective July 31, 2002, by the Professional Ethics Executive Committee. Revised, effective March 31, 2003, by the Professional Ethics Executive Committee. Revised, effective April 30, 2003, by the Professional Ethics Executive Committee.]

[.03] [Formerly paragraph .02 renumbered by adoption of the Code of Professional Conduct on January 12, 1988. Formerly interpretation 101-1, renumbered as 101-4 and moved to paragraph .06, April 1992.]

.04 101-2—Employment or association with attest clients. A firm's independence will be considered to be impaired with respect to a client if a partner or professional employee leaves the firm and is subsequently employed by or associated with that client in a key position unless all the following conditions are met:

1. Amounts due to the former partner or professional employee for his or her previous interest in the firm and for unfunded, vested retirement benefits are not material to the firm, and the underlying formula used to calculate the payments remains fixed during the payout period. Retirement benefits may also be adjusted for inflation and interest may be paid on amounts due.

2. The former partner or professional employee is not in a position to influence the accounting firm's operations or financial policies.

3. The former partner or professional employee does not participate or appear to participate in, and is not associated with the firm, whether or not compensated for such participation or association, once employment or association with the client begins. An appearance of participation or association results from such actions as:

    - The individual provides consultation to the firm.
    - The firm provides the individual with an office and related amenities (for example, secretarial and telephone services).
    - The individual's name is included in the firm's office directory.
    - The individual's name is included as a member of the firm in other membership lists of business, professional, or civic organizations, unless the individual is clearly designated as retired.

4. The ongoing attest engagement team considers the appropriateness or necessity of modifying the engagement procedures to adjust for the risk that, by virtue of the former partner or professional employee's prior knowledge of the audit plan, audit effectiveness could be reduced.

5. The firm assesses whether existing attest engagement team members have the appropriate experience and stature to effectively deal with the former partner or professional employee and his or her work, when that person will have significant interaction with the attest engagement team.

6. The subsequent attest engagement is reviewed to determine whether the engagement team members maintained the appropriate level of skepticism when evaluating the representations and work of the former partner or professional employee, when the person joins the client in a key position within one year of disassociating from the firm and has significant interaction with the attest engagement team. The review should be performed by a professional with appropriate stature, expertise, and objectivity and should be tailored based on the position that the person assumed at the client, the position he or she held at the firm, the nature of the services he or she provided to the client, and other relevant facts and circumstances. Appropriate actions, as deemed necessary, should be taken based on the results of the review.

Responsible members within the firm should implement procedures for compliance with the preceding conditions when firm professionals are employed or associated with attest clients.

With respect to conditions 4, 5, and 6, the procedures adopted will depend on several factors, including whether the former partner or professional employee served as a member of the engagement team, the positions he or she held at the

firm and has accepted at the client, the length of time that has elapsed since the professional left the firm, and the circumstances of his or her departure.[3]

Considering Employment or Association With the Client

When a member of the attest engagement team or an individual in a position to influence the attest engagement intends to seek or discuss potential employment or association with an attest client, or is in receipt of a specific offer of employment from an attest client, independence will be impaired with respect to the client unless the person promptly reports such consideration or offer to an appropriate person in the firm, and removes himself or herself from the engagement until the employment offer is rejected or employment is no longer being sought. When a covered member becomes aware that a member of the attest engagement team or an individual in a position to influence the attest engagement is considering employment or association with a client, the covered member should notify an appropriate person in the firm.

The appropriate person should consider what additional procedures may be necessary to provide reasonable assurance that any work performed for the client by that person was performed with objectivity and integrity as required under rule 102 [ET section 102.01]. Additional procedures, such as reperformance of work already done, will depend on the nature of the engagement and the individual involved.

[Replaces previous interpretation 101-2, *Retired Partners and Firm Independence,* August, 1989, effective August 31, 1989. Revised, effective December 31, 1998, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Revised, effective April 30, 2003, by the Professional Ethics Executive Committee.]

.05 101-3—Performance of other services. A member or his or her firm ("member") who performs an attest engagement for a client may also perform other nonattest services ("other services") for that client. Before a member performs other services for an attest client, he or she must evaluate the effect of such services on his or her independence. In particular, care should be taken not to perform management functions or make management decisions for the attest client, the responsibility for which remains with the client's board of directors and management.

Before performing other services, the member should establish an understanding with the client regarding the objectives of the engagement, the services to be performed, management's responsibilities, the member's responsibilities, and the limitations of the engagement. It is preferable that this understanding be documented in an engagement letter. In addition, the member should be satisfied that the client is in a position to have an informed judgment on the results of the other services and that the client understands its responsibility to—

1. Designate a management-level individual or individuals to be responsible for overseeing the services being provided.
2. Evaluate the adequacy of the services performed and any findings that result.
3. Make management decisions, including accepting responsibility for the results of the other services.

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[3] An inadvertent and isolated failure to meet conditions 4, 5, and 6 would not impair independence provided that the required procedures are performed promptly upon discovery of the failure to do so, and all other provisions of the interpretation are met. [Footnote added, effective April 30, 2003, by the Professional Ethics Executive Committee.]

4. Establish and maintain internal controls, including monitoring ongoing activities.

   Note: Paragraph 33 of PCAOB Auditing Standard No. 2 contains an additional requirement related to audit committee preapproval of internal control-related services.

General Activities

The following are some general activities that would be considered to impair a member's independence:

- Authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of a client or having the authority to do so
- Preparing source documents[4] or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders)
- Having custody of client assets
- Supervising client employees in the performance of their normal recurring activities
- Determining which recommendations of the member should be implemented
- Reporting to the board of directors on behalf of management
- Serving as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent

The examples in the following table identify the effect that performance of other services for an attest client can have on a member's independence. These examples are not intended to be all-inclusive of the types of other services performed by members.

Impact on Independence of Performance of Other Services

Type of Other Service	*Independence Would Not Be Impaired*	*Independence Would Be Impaired*
Bookkeeping	• Record transactions for which management has determined or approved the appropriate account classification, or post coded transactions to a client's general ledger. • Prepare financial statements based on information in the trial balance. • Post client-approved entries to a client's trial balance.	• Determine or change journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval. • Authorize or approve transactions. • Prepare source documents or originate data. • Make changes to source documents without client approval.

(continued)

[4] The documents upon which evidence of an accounting transaction are initially recorded. Source documents are often followed by the creation of many additional records and reports, which do not, however, qualify as initial recordings. Examples of source documents are purchase orders, payroll time cards, and customer orders. [Footnote renumbered by the revision of interpretation 101-2, April 2003.]

Type of Other Service	*Independence Would Not Be Impaired*	*Independence Would Be Impaired*
	• Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client. • Provide data-processing services.	
Payroll and other disbursement	• Using payroll time records provided and approved by the client, generate unsigned checks, or process client's payroll. • Transmit client-approved payroll or other disbursement information to a financial institution provided the client has authorized the member to make the transmission and has made arrangements for the financial institution to limit the corresponding individual payments as to amount and payee. In addition, once transmitted, the client must authorize the financial institution to process the information. • Make electronic payroll tax payments in accordance with U.S. Treasury Department guidelines provided the client has made arrangements for its financial institution to limit such payments to a named payee.[5]	• Accept responsibility to authorize payment of client funds, electronically or otherwise, except as specifically provided for with respect to electronic payroll tax payments. • Accept responsibility to sign or cosign client checks, even if only in emergency situations. • Maintain a client's bank account or otherwise have custody of a client's funds or make credit or banking decisions for the client. • Sign payroll tax return on behalf of client management. • Approve vendor invoices for payment.
Benefit plan administration[6]	• Communicate summary plan data to plan trustee. • Advise client management regarding the application or impact of provisions of the plan document.	• Make policy decisions on behalf of client management. • When dealing with plan participants, interpret the plan document on behalf of management without first obtaining management's concurrence.

[5] Although this type of transaction may be considered by some to be similar to signing checks or disbursing funds, the Professional Ethics Executive Committee concluded that making electronic payroll tax payments under the specified criteria would not impair a member's independence. [Footnote renumbered by the revision of interpretation 101-2, April 2003.]

[6] When auditing plans subject to the Employee Retirement Income Security Act (ERISA), Department of Labor (DOL) regulations, which may be more restrictive, must be followed. [Footnote renumbered by the revision of interpretation 101-2, April 2003.]

Type of Other Service	*Independence Would Not Be Impaired*	*Independence Would Be Impaired*
	• Process transactions (e.g., investment/benefit elections or increase/decrease contributions to the plan; data entry; participant confirmations; and processing of distributions and loans) initiated by plan participants through the member's electronic medium, such as an interactive voice response system or Internet connection or other media. • Prepare account valuations for plan participants using data collected through the member's electronic or other media. • Prepare and transmit participant statements to plan participants based on data collected through the member's electronic or other medium.	• Make disbursements on behalf of the plan. • Have custody of assets of a plan. • Serve a plan as a fiduciary as defined by ERISA.
Investment—advisory or management	• Recommend the allocation of funds that a client should invest in various asset classes, depending upon the client's desired rate of return, risk tolerance, etc. • Perform recordkeeping and reporting of client's portfolio balances including providing a comparative analysis of the client's investments to third-party benchmarks. • Review the manner in which a client's portfolio is being managed by investment account managers, including determining whether the managers are (1) following the guidelines of the client's investment policy statement; (2) meeting the client's investment objectives; and (3) conforming to the client's stated investment styles. • Transmit a client's investment selection to a broker-dealer or equivalent provided the client has authorized the broker-dealer or equivalent to execute the transaction.	• Make investment decisions on behalf of client management or otherwise have discretionary authority over a client's investments. • Execute a transaction to buy or sell a client's investment. • Have custody of client assets, such as taking temporary possession of securities purchased by a client.

(continued)

Type of Other Service	*Independence Would Not Be Impaired*	*Independence Would Be Impaired*
Corporate finance—consulting or advisory	• Assist in developing corporate strategies. • Assist in identifying or introducing the client to possible sources of capital that meet the client's specifications or criteria. • Assist in analyzing the effects of proposed transactions including providing advice to a client during negotiations with potential buyers, sellers, or capital sources. • Assist in drafting an offering document or memorandum. • Participate in transaction negotiations in an advisory capacity. • Be named as a financial adviser in a client's private placement memoranda or offering documents.	• Commit the client to the terms of a transaction or consummate a transaction on behalf of the client. • Act as a promoter, underwriter, broker-dealer, or guarantor of client securities, or distributor of private placement memoranda or offering documents. • Maintain custody of client securities.
Appraisal, valuation or actuarial	• Test the reasonableness of the value placed on an asset or liability included in a client's financial statements by preparing a separate valuation of that asset or liability. • Perform a valuation of a client's business when all significant matters of judgment are determined or approved by the client and the client is in a position to have an informed judgment on the results of the valuation.	• Prepare a valuation of an employer's securities contained in an employee stock ownership plan (ESOP) to support transactions with participants, plan contributions, and allocations within the ESOP, when the client is not in a position to have an informed judgment on the results of this valuation. • Prepare an appraisal, valuation, or actuarial report using assumptions determined by the member and not approved by the client.
Executive or employee search	• Recommend a position description or candidate specifications. • Solicit and perform screening of candidates and recommend qualified candidates to a client based on the client-approved criteria (e.g., required skills and experience). • Participate in employee hiring or compensation discussions in an advisory capacity.	• Commit the client to employee compensation or benefit arrangements. • Hire or terminate client employees.

Type of Other Service	*Independence Would Not Be Impaired*	*Independence Would Be Impaired*
Business risk consulting	• Provide assistance in assessing the client's business risks and control processes. • Recommend a plan for making improvements to a client's control processes and assist in implementing these improvements.	• Make or approve business risk decisions. • Present business risk considerations to the board or others on behalf of management.
Information systems—design, installation or integration	• Design, install or integrate a client's information system, provided the client makes all management decisions. • Customize a prepackaged accounting or information system, provided the client makes all management decisions. • Provide the initial training and instruction to client employees on a newly implemented information and control system.	• Supervise client personnel in the daily operation of a client's information system. • Operate a client's local area network (LAN) system when the client has not designated a competent individual, preferably within senior management, to be responsible for the LAN.

[Formerly paragraph .04, renumbered by adoption of the Code of Professional Conduct on January 12, 1988. Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, effective May 31, 1999, by the Professional Ethics Executive Committee. Revised, effective April 30, 2000, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

.06 101-4—Honorary directorships and trusteeships of not-for-profit organization. Partners or professional employees of a firm (individual) may be asked to lend the prestige of their names to not-for-profit organizations that limit their activities to those of a charitable, religious, civic, or similar nature by being named as a director or a trustee. An individual who permits his or her name to be used in this manner would not be considered to impair independence under rule 101 [ET section 101.01] provided his or her position is clearly honorary, and he or she cannot vote or otherwise participate in board or management functions. If the individual is named in letterheads and externally circulated materials, he or she must be identified as an honorary director or honorary trustee. [Formerly paragraph .05, renumbered by adoption of the Code of Professional Conduct on January 12, 1988. Formerly interpretation 101-1. Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Renumbered as interpretation 101-4 and moved from paragraph .03, April, 1992. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

.07 101-5—Loans from financial institution clients and related terminology. Interpretation 101-1.A.4 [ET section 101.02] provides that, except as permitted in this interpretation, independence shall be considered to be

impaired if a **covered member**[‖] has any **loan** to or from a **client**, any officer or director of the client, or any individual owning ten percent or more of the client's outstanding equity securities or other ownership interests. This interpretation describes the conditions a covered member (or his or her **immediate family**) must meet in order to apply an exception for a "Grandfathered Loan" or "Other Permitted Loan."

Grandfathered Loans

Unsecured loans that are not material to the covered member's net worth, home mortgages,[7] and other secured loans[7] are grandfathered if:

(1) they were obtained from a **financial institution** under that institution's **normal lending procedures, terms, and requirements**,

(2) after becoming a covered member they are kept current as to all terms at all times and those terms do not change in any manner not provided for in the original loan agreement,[8] and

(3) they were:

a) obtained from the financial institution prior to its becoming a client requiring independence; or

b) obtained from a financial institution for which independence was not required and were later sold to a client for which independence is required; or

c) obtained prior to February 5, 2001 and met the requirements of previous provisions of Interpretation 101-5 [ET section 101.07] covering grandfathered loans; or

d) obtained between February 5, 2001 and May 31, 2002, and the covered member was in compliance with the applicable independence requirements of the SEC during that period; or

e) obtained after May 31, 2002 from a financial institution client requiring independence by a borrower prior to his or her becoming a covered member with respect to that client

In determining when a loan was obtained, the date a loan commitment or line of credit is granted must be used, rather than the date a transaction closes or funds are obtained.

[‖] Terms shown in **boldface** type upon first usage in this interpretation are defined in ET section 92, *Definitions*.

[7] The value of the collateral securing a home mortgage or other secured loan should equal or exceed the remaining balance of the grandfathered loan during the term of the loan. If the value of the collateral is less than the remaining balance of the grandfathered loan, the portion of the loan that exceeds the value of the collateral must not be material to the covered member's net worth. [Footnote added, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote renumbered by the revision of interpretation 101-2, April 2003.]

[8] Changes in the terms of the loan include, but are not limited to, a new or extended maturity date, a new interest rate or formula, revised collateral, or revised or waived covenants. [Footnote added, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote renumbered by the revision of interpretation 101-2, April 2003.]

For purposes of applying the grandfathered loans provision when the covered member is a partner in a partnership:

- a loan to a limited partnership (or similar type of entity) or a general partnership would be ascribed to each covered member who is a partner in the partnership on the basis of their legal liability as a limited or general partner if:
  - — the covered member's interest in the limited partnership, either individually or combined with the interest of one or more covered members, exceeds 50 percent of the total limited partnership interest; or
  - — the covered member, either individually or together with one or more covered members, can control the general partnership.
- even if no amount of a partnership loan is ascribed to the covered member(s) identified above, independence is considered to be impaired if the partnership renegotiates the loan or enters into a new loan that is not one of the permitted loans described below.

Other Permitted Loans

This interpretation permits only the following new loans to be obtained from a financial institution client for which independence is required. These loans must be obtained under the institution's normal lending procedures, terms, and requirements and must, at all times, be kept current as to all terms.

1. Automobile loans and leases collateralized by the automobile.
2. Loans fully collateralized by the cash surrender value of an insurance policy.
3. Loans fully collateralized by cash deposits at the same financial institution (e.g., "passbook loans").
4. Credit cards and cash advances where the aggregate outstanding balance on the current statement is reduced to $5,000 or less by the payment due date.

Related prohibitions that may be more restrictive are prescribed by certain state and federal agencies having regulatory authority over such financial institutions. Broker-dealers, for example, are subject to regulation by the Securities and Exchange Commission.

[Revised, November 30, 1987, by the Professional Ethics Executive Committee. Formerly paragraph .06, renumbered by adoption of the Code of Professional Conduct on January 12, 1988. References revised to reflect issuance of AICPA Code of Professional Conduct on January 12, 1988. Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, November 1991, effective January 1, 1992 with earlier application encouraged, by the Professional Ethics Executive Committee. Revised, effective February 28, 1998 by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Revised, November 2002, by the Professional Ethics Executive Committee.]

.08 101-6—The effect of actual or threatened litigation on independence. In some circumstances, independence may be considered to be impaired

as a result of litigation or the expressed intention to commence litigation as discussed below.

Litigation between client and member

The relationship between the management of the client and a covered member must be characterized by complete candor and full disclosure regarding all aspects of the client's business operations. In addition, there must be an absence of bias on the part of the covered member so that he or she can exercise professional judgment on the financial reporting decisions made by the management. When the present management of a client company commences, or expresses an intention to commence, legal action against a covered member, the covered member and the client's management may be placed in adversarial positions in which the management's willingness to make complete disclosures and the covered member's objectivity may be affected by self-interest.

For the reasons outlined above, independence may be impaired whenever the covered member and the covered member's client or its management are in threatened or actual positions of material adverse interests by reason of threatened or actual litigation. Because of the complexity and diversity of the situations of adverse interests which may arise, however, it is difficult to prescribe precise points at which independence may be impaired. The following criteria are offered as guidelines:

1. The commencement of litigation by the present management alleging deficiencies in audit work for the client would be considered to impair independence.

2. The commencement of litigation by the covered member against the present management alleging management fraud or deceit would be considered to impair independence.

3. An expressed intention by the present management to commence litigation against the covered member alleging deficiencies in audit work for the client would be considered to impair independence if the auditor concludes that it is probable that such a claim will be filed.

4. Litigation not related to performance of an attest engagement for the client (whether threatened or actual) for an amount not material to the covered member's firm[9] or to the client company[9] would not generally be considered to affect the relationship in such a way as to impair independence. Such claims may arise, for example, out of disputes as to billings for services, results of tax or management services advice or similar matters.

Litigation by security holders

A covered member may also become involved in litigation ("primary litigation") in which the covered member and the client or its management are defendants. Such litigation may arise, for example, when one or more stockholders bring

[9] Because of the complexities of litigation and the circumstances under which it may arise, it is not possible to prescribe meaningful criteria for measuring materiality; accordingly, the covered member should consider the nature of the controversy underlying the litigation and all other relevant factors in reaching a judgment. [Footnote renumbered and revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote subsequently renumbered by the revision of interpretation 101-2, April 2003.]

a stockholders' derivative action or a so-called "class action" against the client or its management, its officers, directors, underwriters and covered members under the securities laws. Such primary litigation in itself would not alter fundamental relationships between the client or its management and the covered member and therefore would not be deemed to have an adverse impact on independence. These situations should be examined carefully, however, since the potential for adverse interests may exist if cross-claims are filed against the covered member alleging that the covered member is responsible for any deficiencies or if the covered member alleges fraud or deceit by the present management as a defense. In assessing the extent to which independence may be impaired under these conditions, the covered member should consider the following additional guidelines:

1. The existence of cross-claims filed by the client, its management, or any of its directors to protect a right to legal redress in the event of a future adverse decision in the primary litigation (or, in lieu of cross-claims, agreements to extend the statute of limitations) would not normally affect the relationship between client management and the covered member in such a way as to impair independence, unless there exists a significant risk that the cross-claim will result in a settlement or judgment in an amount material to the covered member's firm[10] or to the client.
2. The assertion of cross-claims against the covered member by underwriters would not generally impair independence if no such claims are asserted by the client or the present management.
3. If any of the persons who file cross-claims against the covered member are also officers or directors of other clients of the covered member, independence with respect to such other clients would not generally be considered to be impaired.

Other third-party litigation

Another type of third-party litigation against the covered member may be commenced by a lending institution, other creditor, security holder, or insurance company who alleges reliance on financial statements of the client with which the covered member is associated as a basis for extending credit or insurance coverage to the client. In some instances, an insurance company may commence litigation (under subrogation rights) against the covered member in the name of the client to recover losses reimbursed to the client. These types of litigation would not normally affect independence with respect to a client who is either not the plaintiff or is only the nominal plaintiff, since the relationship between the covered member and client management would not be affected. They should be examined carefully, however, since the potential for adverse interests may exist if the covered member alleges, in his defense, fraud, or deceit by the present management.

If the real party in interest in the litigation (e.g., the insurance company) is also a client of the covered member ("the plaintiff client"), independence with respect to the plaintiff client may be impaired if the litigation involves a significant risk of a settlement or judgment in an amount which would be material to the covered member's firm[11] or to the plaintiff client.

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[10] See footnote 9. [Footnote renumbered, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote subsequently renumbered by the revision of interpretation 101-2, April 2003.]

[11] See footnote 9. [Footnote renumbered, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote subsequently renumbered by the revision of interpretation 101-2, April 2003.]

Effects of impairment of independence

If the covered member believes that the circumstances would lead a reasonable person having knowledge of the facts to conclude that the actual or intended litigation poses an unacceptable threat to independence, the covered member should either (*a*) disengage himself or herself, or (*b*) disclaim an opinion because of lack of independence. Such disengagement may take the form of resignation or cessation of any attest engagement then in progress pending resolution of the issue between the parties.

Termination of impairment

The conditions giving rise to a lack of independence are generally eliminated when a final resolution is reached and the matters at issue no longer affect the relationship between the covered member and client. The covered member should carefully review the conditions of such resolution to determine that all impairments to the covered member's objectivity have been removed.

[Formerly paragraph .07, renumbered by adoption of the Code of Professional Conduct on January 12, 1988. Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, effective September 30, 1995, by the Professional Ethics Executive Committee, by deletion of subhead and paragraph and reissuance as ethics ruling No. 100, *Actions Permitted When Independence is Impaired*, under rule 101. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[.09] [101-7]—[Deleted] [Formerly paragraph .08, renumbered by adoption of the Code of Professional Conduct on January 12, 1988.]

.10 101-8—Effect on independence of financial interests in nonclients having investor or investee relationships with a covered member's client.

Introduction

Financial interests in nonclients that are related in various ways to a client may impair independence. Situations in which the nonclient investor is a partnership are covered in other rulings [ET section 191.138–.139, .158–.159, and .162–.163].

Terminology

The following specifically identified terms are used in this interpretation as indicated:

1. Client. The term client means the person or entity with whose financial statements a covered member is associated.

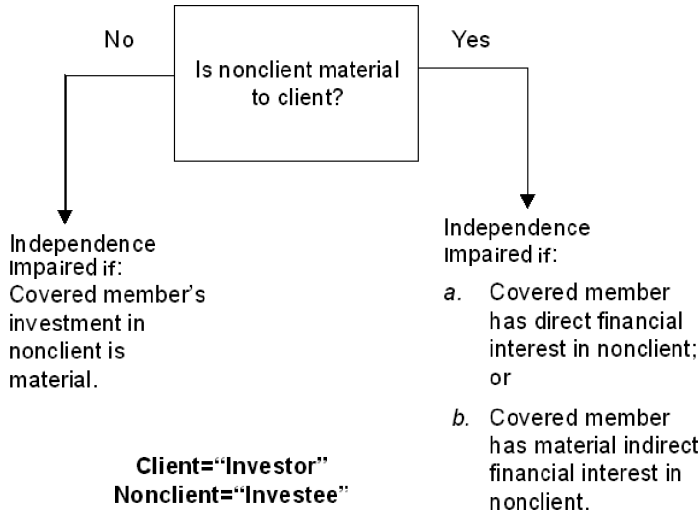
2. Significant Influence. The term significant influence is as defined in Accounting Principles Board (APB) Opinion 18 [AC I82].

3. Investor. The term investor means (*a*) a parent, (*b*) a general partner, or (*c*) a natural person or corporation that has the ability to exercise significant influence.

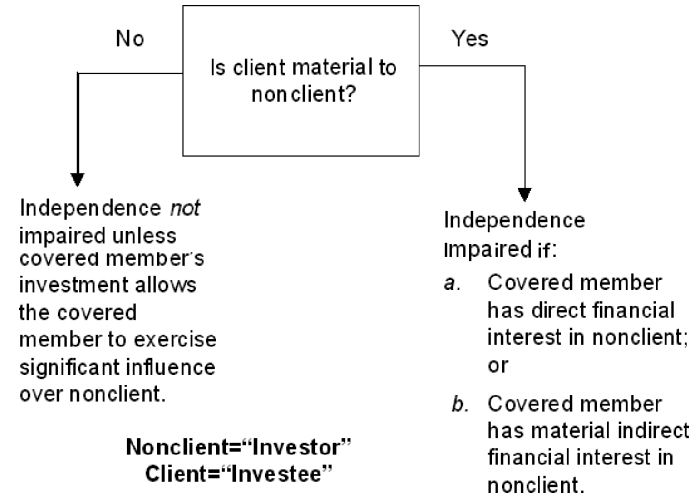
4. Investee. The term investee means (*a*) a subsidiary or (*b*) an entity over which an investor has the ability to exercise significant influence.

Interpretation

Where a nonclient investee is material to a client investor, any direct or material indirect financial interest of a covered member in the nonclient investee would be considered to impair independence with respect to the client investor. If the nonclient investee is immaterial to the client investor, a covered member's material investment in the nonclient investee would cause an impairment of independence.



Where a client investee is material to nonclient investor, any direct or material indirect financial interest of a covered member in the nonclient investor would be considered to impair independence with respect to the client investee. If the client investee is immaterial to the nonclient investor, and if a covered member's financial interest in the nonclient investor allows the covered member to exercise significant influence over the actions of the nonclient investor, independence would be considered to be impaired.



Other relationships, such as those involving brother-sister common control or client-nonclient joint ventures, may affect the appearance of independence. The covered member should make a reasonable inquiry to determine whether such relationships exist, and if they do, careful consideration should be given to whether the financial interests in question would lead a reasonable observer to conclude that the specified relationships pose an unacceptable threat to independence.

In general, in brother-sister common control situations, an immaterial financial interest of a covered member in the nonclient investee would not impair independence with respect to the client investee, provided the covered member could not exercise significant influence over the nonclient investor. However, if a covered member's financial interest in a nonclient investee is material, the covered member could be influenced by the nonclient investor, thereby impairing independence with respect to the client investee. In like manner, in a joint venture situation, an immaterial financial interest of a covered member in the nonclient investor would not impair the independence of the covered member with respect to the client investor, provided that the covered member could not exercise significant influence over the nonclient investor.

If a covered member does not and could not reasonably be expected to have knowledge of the financial interests or relationship described in this interpretation, independence would not be considered to be impaired under this interpretation.

[Revised, December 31, 1983, by the Professional Ethics Executive Committee. Formerly paragraph .09 renumbered by adoption of the Code of Professional Conduct on January 12, 1988. References changed to reflect the issuance of the AICPA Code of Professional Conduct on January 12, 1988. Replaces previous interpretation 101-8, *Effect on Independence of Financial Interests in Nonclients Having Investor or Investee Relationships With a Member's Client*, April 1991, effective April 30, 1991. Revised, December 31, 1991, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[.11] [101-9]—[Deleted]

.12 101-10—The effect on independence of relationships with entities included in the governmental financial statements.[12] For purposes of this Interpretation, a financial reporting entity's basic financial statements, issued in conformity with generally accepted accounting principles in the United States of America, include the government-wide financial statements (consisting of the entity's governmental activities, business-type activities, and discretely presented component units), the fund financial statements (consisting of major funds, nonmajor governmental and enterprise funds, internal service funds, blended component units, and fiduciary funds) and other entities disclosed in the notes to the basic financial statements. Entities that should be disclosed in the notes to the basic financial statements include, but are not limited to, related organizations, joint ventures, jointly governed organizations, and component units of another government with characteristics of a joint venture or jointly governed organization.

[12] Except for a financial reporting entity's basic financial statements, which is defined within the text of this Interpretation, certain terminology used throughout the Interpretation is specifically defined by the Governmental Accounting Standards Board. [Footnote renumbered, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote subsequently renumbered by the revision of interpretation 101-2, April 2003.]

Auditor of Financial Reporting Entity

A covered member issuing a report on the basic financial statements of the financial reporting entity must be independent of the financial reporting entity, as defined in paragraph 1 of this Interpretation. However, independence is not required with respect to any major or nonmajor fund, internal service fund, fiduciary fund, or component unit or other entities disclosed in the financial statements, where the primary auditor explicitly states reliance on other auditors reports thereon. In addition, independence is not required with respect to an entity disclosed in the notes to the basic financial statements, if the financial reporting entity is not financially accountable for the organization and the required disclosure does not include financial information. For example, a disclosure limited to the financial reporting entity's ability to appoint the governing board members would not require a member to be independent of that organization.

However, the covered member and his or her immediate family should not hold a key position with a major fund, nonmajor fund, internal service fund, fiduciary fund, or component unit of the financial reporting entity or other entity that should be disclosed in the notes to the basic financial statements.

Auditor of a Major Fund, Nonmajor Fund, Internal Service Fund, Fiduciary Fund, or Component Unit of the Financial Reporting Entity or Other Entity That Should Be Disclosed in the Notes to the Basic Financial Statements

A covered member who is auditing the financial statements of a major fund, nonmajor fund, internal service fund, fiduciary fund, or component unit of the financial reporting entity or an entity that should be disclosed in the notes to the basic financial statements of the financial reporting entity, but is not auditing the primary government, should be independent with respect to those financial statements that the covered member is reporting upon. The covered member is not required to be independent of the primary government or other funds or component units of the reporting entity or entities that should be disclosed in the notes to the basic financial statements. However, the covered member and his or her immediate family should not hold a key position within the primary government. For purposes of this Interpretation, a covered member and immediate family member would not be considered employed by the primary government if the exceptions provided for in ET section 92.03 are met.[13–14]

[Formerly paragraph .11, renumbered by adoption of the Code of Professional Conduct on January 12, 1988. References changed to reflect the issuance of the AICPA Code of Professional Conduct on January 12, 1988. Replaces previous interpretation 101-10, *The Effect on Independence of Relationships Proscribed by Rule 101 and its Interpretations With Nonclient Entities Included With a Member's Client in the Financial Statements of a Governmental Reporting Entity*, April 1991, effective April 30, 1991. Replaces previous interpretation 101-10, *The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements*, January 1996, effective January 31, 1996. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Revised, effective March 31, 2003, by the Professional Ethics Executive Committee.]

[13–14] [Footnotes deleted by the Professional Ethics Executive Committee, March 2003. Footnotes renumbered by the revision of interpretation 101-2, April 2003.]

.13 101-11—Modified application of rule 101 for certain engagements to issue restricted-use reports under the Statements on Standards for Attestation Engagements. Rule 101: *Independence* [ET section 101.01], and its interpretations and rulings apply to all attest engagements. However, for purposes of performing engagements to issue reports under the Statements on Standards for Attestation Engagements (SSAEs) that are restricted to identified parties, only the following covered members, and their immediate families, are required to be independent with respect to the responsible party[15] in accordance with rule 101 [ET section 101.01]:

- Individuals participating on the attest engagement team;
- Individuals who directly supervise or manage the attest engagement partner; and
- Individuals who consult with the attest engagement team regarding technical or industry-related issues specific to the attest engagement.

In addition, independence would be considered to be impaired if the firm had a financial relationship covered by interpretation 101-1.A [ET section 101.02] with the responsible party that was material to the firm.

In cases where the firm provides non-attest services to the responsible party that are proscribed under interpretation 101-3 [ET section 101.05] and that do not directly relate to the subject matter of the attest engagement, independence would not be considered to be impaired.

In circumstances where the individual or entity that engages the firm is not the responsible party or associated with the responsible party, individuals on the attest engagement team need not be independent of the individual or entity, but should consider their responsibilities under interpretation 102-2 [ET section 102.03] with regard to any relationships that may exist with the individual or entity that engages them to perform these services.

This interpretation does not apply to an engagement performed under the Statements on Auditing Standards or Statements on Standards for Accounting and Review Services, or to an examination or review engagement performed under the Statements on Standards for Attestation Engagements.

[Replaces previous interpretation 101-11, *Independence and Attest Engagements*, January 1996, effective January 31, 1996. Revised, effective November 30, 2001, by the Professional Ethics Executive Committee.]

.14 101-12—Independence and cooperative arrangements with clients. Independence will be considered to be impaired if, during the period of a professional engagement, a member or his or her firm had any cooperative arrangement with the client that was material to the member's firm or to the client.

Cooperative Arrangement—A cooperative arrangement exists when a member's firm and a client jointly participate in a business activity. The following are examples, which are not all inclusive, of cooperative arrangements:

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[15] As defined in the SSAEs. [Footnote renumbered, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote subsequently renumbered by the revision of interpretation 101-2, April 2003.]

1. Prime/subcontractor arrangements to provide services or products to a third party
2. Joint ventures to develop or market products or services
3. Arrangements to combine one or more services or products of the firm with one or more services or products of the client and market the package with references to both parties
4. Distribution or marketing arrangements under which the firm acts as a distributor or marketer of the client's products or services, or the client acts as the distributor or marketer of the products or services of the firm

Nevertheless, joint participation with a client in a business activity does not ordinarily constitute a cooperative arrangement when all the following conditions are present:

a. The participation of the firm and the participation of the client are governed by separate agreements, arrangements, or understandings.

b. The firm assumes no responsibility for the activities or results of the client, and vice versa.

c. Neither party has the authority to act as the representative or agent of the other party.

In addition, the member's firm should consider the requirements of rule 302 [ET section 302.01] and rule 503 [ET section 503.01].

[Effective November 30, 1993. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

.15 101-13—Extended audit services. A member or his or her firm ("member") may be asked by a client, for which the member performs an attest engagement, to perform extended audit services. These services may include assistance in the performance of the client's internal audit activities and/or an extension of the member's audit service beyond the requirements of generally accepted auditing standards (hereinafter referred to as "extended audit services").

A member's performance of extended audit services would not be considered to impair independence with respect to a client for which the member also performs an attest engagement, provided that the member or his or her firm is not an employee of the client or does not act or appear to act in a capacity equivalent to a member of client management.

The responsibilities of the client, including its board of directors, audit committee, and management, and the responsibilities of the member, as described below, should be understood by both the member and the client. It is preferable that this understanding be documented in an engagement letter that indicates that the member may not perform management functions or make management decisions.

A member should be satisfied that the client understands its responsibility for establishing and maintaining internal control and directing the internal audit function, if any. As part of its responsibility to establish and maintain internal control, management monitors internal control to assess the quality of its performance over time. Monitoring can be accomplished through ongoing activities, separate evaluations or a combination of both.

Ongoing monitoring activities are the procedures designed to assess the quality of internal control performance over time and that are built into the normal recurring activities of an entity and include regular management and supervisory activities, comparisons, reconciliations and other routine actions. Separate evaluations focus on the continued effectiveness of a client's internal control. A member's independence would not be impaired by the performance of separate evaluations of the effectiveness of a client's internal control, including separate evaluations of the client's ongoing monitoring activities.

The member should understand that, with respect to the internal audit function, the client is responsible for—

- Designating a competent individual or individuals, preferably within senior management, to be responsible for the internal audit function
- Determining the scope, risk and frequency of internal audit activities, including those to be performed by the member providing extended audit services
- Evaluating the findings and results arising from the internal audit activities, including those performed by the member providing extended audit services
- Evaluating the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining reports from the member

The member should be satisfied that the board of directors and/or audit committee is informed of roles and responsibilities of both client management and the member with respect to the engagement to provide extended audit services as a basis for the board of directors and/or audit committee to establish guidelines for both management and the member to follow in carrying out these responsibilities and monitoring how well the respective responsibilities have been met.

The member should be responsible for performing the audit procedures in accordance with the terms of the engagement and reporting thereon. The day-to-day performance of the audit procedures should be directed, reviewed, and supervised by the member. The report should include information that allows the individual responsible for the internal audit function to evaluate the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures. This report may include recommendations for improvements in systems, processes, and procedures. The member may assist the individual responsible for the internal audit function in performing preliminary audit risk assessments, preparing audit plans, and recommending audit priorities. However, the member should not undertake any responsibilities that are required, as described above, to be performed by the individual responsible for the internal audit function.

Performing procedures that are generally of the type considered to be extensions of the member's audit scope applied in the audit of the client's financial statements, such as confirming of accounts receivable and analyzing fluctuations in account balances, would not impair the independence even if the extent of such testing exceeds that required by generally accepted auditing standards.

The following are examples of activities that, if performed as part of an extended audit service, would be considered to impair independence:

- Performing ongoing monitoring activities or control activities (for example, reviewing loan originations as part of the client's approval process or reviewing customer credit information as part of the customer's sales authorization process) that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both, and performing routine activities in connection with the client's operating or production processes that are equivalent to those of an ongoing compliance or quality control function
- Determining which, if any, recommendations for improving the internal control system should be implemented
- Reporting to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function
- Authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client
- Preparing source documents on transactions
- Having custody of assets
- Approving or being responsible for the overall internal audit work plan including the determination of the internal audit risk and scope, project priorities and frequency of performance of audit procedures
- Being connected with the client as an employee or in any capacity equivalent to a member of client management (for example, being listed as an employee in client directories or other client publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the client's internal audit function, or using the client's letterhead or internal correspondence forms in communications)

The foregoing list in not intended to be all inclusive.

[Effective August 31, 1996. Revised, effective September 30, 1999, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

.16 101-14—The effect of alternative practice structures on the applicability of independence rules. Because of changes in the manner in which **members**[#] are structuring their practices, the AICPA's professional ethics executive committee (PEEC) studied various alternatives to "traditional structures" to determine whether additional independence requirements are necessary to ensure the protection of the public interest.

In many "nontraditional structures," a substantial (the nonattest) portion of a member's practice is conducted under public or private ownership, and the attest portion of the practice is conducted through a separate firm owned and controlled by the member. All such structures must comply with applicable laws, regulations, and Rule 505, *Form of Organization and Name* [ET section 505.01]. In complying with laws, regulations, and rule 505 [ET section 505.01], many elements of quality control are required to ensure that the public interest is adequately protected. For example, all services performed by members and

[#] Terms shown in **boldface** type upon first usage in this interpretation are defined in ET section 92, *Definitions*. [Footnote added, November 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

persons over whom they have control must comply with standards promulgated by AICPA Council-designated bodies, and, for all other firms providing attest services, enrollment is required in an AICPA-approved practice-monitoring program. Finally, and importantly, the members are responsible, financially and otherwise, for all the attest work performed. Considering the extent of such measures, PEEC believes that the additional independence rules set forth in this interpretation are sufficient to ensure that attest services can be performed with objectivity and, therefore, the additional rules satisfactorily protect the public interest.

Rule 505 [ET section 505.01] and the following independence rules for an alternative practice structure (APS) are intended to be conceptual and applicable to all structures where the "traditional firm" engaged in attest services is closely aligned with another organization, public or private, that performs other professional services. The following paragraph and the chart below provide an example of a structure in use at the time this interpretation was developed. Many of the references in this interpretation are to the example. PEEC intends that the concepts expressed herein be applied, in spirit and in substance, to variations of the example structure as they develop.

The example APS in this interpretation is one where an existing CPA practice ("Oldfirm") is sold by its owners to another (possibly public) entity ("PublicCo"). PublicCo has subsidiaries or divisions such as a bank, insurance company or broker-dealer, and it also has one or more professional service subsidiaries or divisions that offer to clients nonattest professional services (e.g., tax, personal financial planning, and management consulting). The owners and employees of Oldfirm become employees of one of PublicCo's subsidiaries or divisions and may provide those nonattest services. In addition, the owners of Oldfirm form a new CPA firm ("Newfirm") to provide attest services. CPAs, including the former owners of Oldfirm, own a majority of Newfirm (as to vote and financial interests). Attest services are performed by Newfirm and are supervised by its owners. The arrangement between Newfirm and PublicCo (or one of its subsidiaries or divisions) includes the lease of employees, office space and equipment; the performance of back-office functions such as billing and collections; and advertising. Newfirm pays a negotiated amount for these services.

APS Independence Rules for Covered Members

The term **covered member** in an APS includes both employed and leased individuals. The **firm** in such definition would be Newfirm in the example APS. All covered members, including the firm, are subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety. For example, no covered member may have, among other things, a direct financial interest in or a loan to or from an attest client of Newfirm.

Partners of one Newfirm generally would not be considered partners of another Newfirm except in situations where those partners perform services for the other Newfirm or where there are significant shared economic interests between partners of more than one Newfirm. If, for example, partners of Newfirm 1 perform services in Newfirm 2, such owners would be considered to be partners of both Newfirms for purposes of applying the independence rules.

APS Independence Rules for Persons and Entities Other Than Covered Members

As stated above, the independence rules normally extend only to those persons and entities included in the definition of covered member. This normally would include only the "traditional firm" (Newfirm in the example APS), those covered members who own or are employed or leased by Newfirm, and entities controlled by one or more of such persons. Because of the close alignment in many

APSs between persons and entities included in covered member and other persons and entities, to ensure the protection of the public interest, PEEC believes it appropriate to require restrictions in addition to those required in a traditional firm structure. Those restrictions are divided into two groups:

1. *Direct Superiors.* Direct Superiors are defined to include those persons so closely associated with a partner or manager who is a covered member, that such persons can *directly control* the activities of such partner or manager. For this purpose, a person who can *directly control* is the immediate superior of the partner or manager who has the power to direct the activities of that person so as to be able to directly or indirectly (e.g. through another entity over which the Direct Superior can exercise significant influence[16]) derive a benefit from that person's activities. Examples would be the person who has day-to-day responsibility for the activities of the partner or manager and is in a position to recommend promotions and compensation levels. This group of persons is, in the view of PEEC, so closely aligned through direct reporting relationships with such persons that their interests would seem to be inseparable. *Consequently, persons considered Direct Superiors, and entities within the APS over which such persons can exercise significant influence*[17] *are subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety*.

2. *Indirect Superiors and Other PublicCo Entities.* Indirect Superiors are those persons who are one or more levels above persons included in Direct Superior. Generally, this would start with persons in an organization structure to whom Direct Superiors report and go up the line from there. PEEC believes that certain restrictions must be placed on Indirect Superiors, but also believes that such persons are sufficiently removed from partners and managers who are covered persons to permit a somewhat less restrictive standard. Indirect Superiors are not connected with partners and managers who are covered members through direct reporting relationships; there always is a level in between. The PEEC also believes that, for purposes of the following, the definition of Indirect Superior also includes the **immediate family** of the Indirect Superior.

PEEC carefully considered the risk that an Indirect Superior, through a Direct Superior, might attempt to influence the decisions made during the engagement for a Newfirm attest client. PEEC believes that this risk is reduced to a sufficiently low level by prohibiting certain relationships between Indirect Superiors and Newfirm attest clients and by applying a materiality concept

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[16] For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in Accounting Principles Board Opinion No. 18 [AC section I82] and its interpretations to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive. [Footnote added, November 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote renumbered by the revision of interpretation 101-2, April 2003.]

[17] For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in Accounting Principles Board Opinion No. 18 [AC section I82] and its interpretations to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive. [Footnote added, November 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote renumbered by the revision of interpretation 101-2, April 2003.]

with respect to financial relationships. If the financial relationship is not material to the Indirect Superior, PEEC believes that he or she would not be sufficiently financially motivated to attempt such influence particularly with sufficient effort to overcome the presumed integrity, objectivity and strength of character of individuals involved in the engagement.

Similar standards also are appropriate for Other PublicCo Entities. These entities are defined to include PublicCo and all entities consolidated in the PublicCo financial statements that are not subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety.

The rules for Indirect Superiors and Other PublicCo Entities are as follows:

A. Indirect Superiors and Other PublicCo Entities may *not* have a relationship contemplated by interpretation 101-1.A [ET section 101.02] (e.g., investments, loans, etc.) with an attest client of Newfirm that is material. In making the test for materiality for financial relationships of an Indirect Superior, all the financial relationships with an attest client held by such person should be aggregated and, to determine materiality, assessed in relation to the person's net worth. In making the materiality test for financial relationships of Other PublicCo Entities, all the financial relationships with an attest client held by such entities should be aggregated and, to determine materiality, assessed in relation to the consolidated financial statements of PublicCo. In addition, any Other PublicCo Entity over which an Indirect Superior has direct responsibility cannot have a financial relationship with an attest client that is material in relation to the Other PublicCo Entity's financial statements.

B. Further, financial relationships of Indirect Superiors or Other PublicCo Entities should not allow such persons or entities to exercise significant influence[18] over the attest client. In making the test for significant influence, financial relationships of all Indirect Superiors and Other PublicCo Entities should be aggregated.

C. Neither Other PublicCo Entities nor any of their employees may be connected with an attest client of Newfirm as a promoter, underwriter, voting trustee, director or officer.

D. Except as noted in C above, Indirect Superiors and Other PublicCo Entities may provide services to an attest client of Newfirm that would impair independence if performed by Newfirm. For example, trustee and asset custodial services in the ordinary course of business by a bank subsidiary of PublicCo would be acceptable as long as the bank was not subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety.

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[18] For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in Accounting Principles Board Opinion No. 18 [AC section I82] and its interpretations to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive. [Footnote added, November 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote renumbered by the revision of interpretation 101-2, April 2003.]

Other Matters

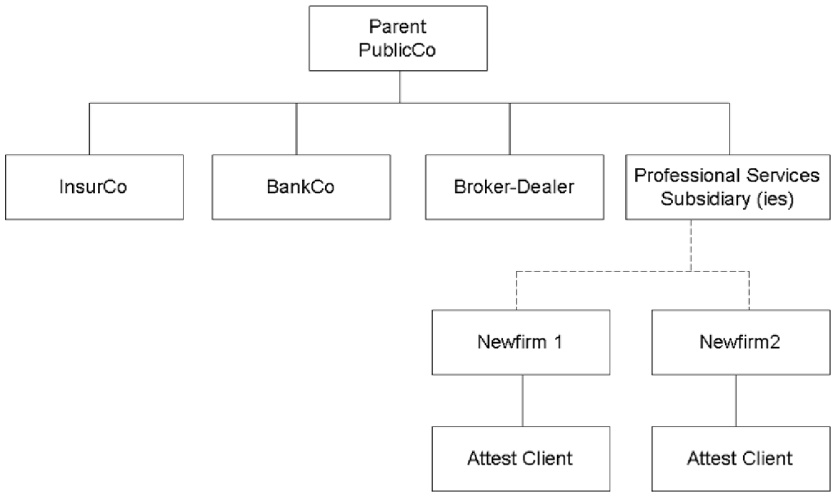
1. An example, using the chart below, of the application of the concept of Direct and Indirect Superiors would be as follows: The chief executive of the local office of the Professional Services Subsidiary (PSS), where the partners of Newfirm are employed, would be a Direct Superior. The chief executive of PSS itself would be an Indirect Superior, and there may be Indirect Superiors in between such as a regional chief executive of all PSS offices within a geographic area.

2. PEEC has concluded that Newfirm (and its partners and employees) may not perform an **attest engagement** for PublicCo or any of its subsidiaries or divisions.

3. PEEC has concluded that independence would be considered to be impaired with respect to an attest client of Newfirm if such attest client holds an investment in PublicCo that is material to the attest client or allows the attest client to exercise significant influence[19] over PublicCo.

4. When making referrals of services between Newfirm and any of the entities within PublicCo, a member should consider the provisions of Interpretation 102-2, *Conflicts of Interest* [ET section 102.03].

Alternative Practice Structure (APS) Model



[Effective February 28, 1999; Revised, November 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[19] For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in Accounting Principles Board Opinion No. 18 [AC section I82] and its interpretations to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive. [Footnote added, November 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote renumbered by the revision of interpretation 101-2, April 2003.]

ET Section 102

Integrity and Objectivity

Source: Auditing Standard Nos. 8–15.

.01 Rule 102—Integrity and objectivity. In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

[As adopted January 12, 1988.]

Interpretations under Rule 102—Integrity and Objectivity

.02 102-1—Knowing misrepresentations in the preparation of financial statements or records. A member shall be considered to have knowingly misrepresented facts in violation of rule 102 [ET section 102.01] when he or she knowingly—

a. Makes, or permits or directs another to make, materially false and misleading entries in an entity's financial statements or records; or

b. Fails to correct an entity's financial statements or records that are materially false and misleading when he or she has the authority to record an entry; or

c. Signs, or permits or directs another to sign, a document containing materially false and misleading information.

[Revised, effective May 31, 1999, by the Professional Ethics Executive Committee.]

.03 102-2—Conflicts of interest. A conflict of interest may occur if a member performs a professional service for a client or employer and the member or his or her firm has a relationship with another person, entity, product, or service that could, in the member's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the member's objectivity. If the member believes that the professional service can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client, employer, or other appropriate parties, the rule shall not operate to prohibit the performance of the professional service. When making the disclosure, the member should consider Rule 301, *Confidential Client Information* [ET section 301.01].

Certain professional engagements, such as audits, reviews, and other attest services, require independence. Independence impairments under rule 101 [ET section 101.01], its interpretations, and rulings cannot be eliminated by such disclosure and consent.

The following are examples, not all-inclusive, of situations that should cause a member to consider whether or not the client, employer, or other appropriate parties could view the relationship as impairing the member's objectivity:

- A member has been asked to perform litigation services for the plaintiff in connection with a lawsuit filed against a client of the member's firm.
- A member has provided tax or personal financial planning (PFP) services for a married couple who are undergoing a divorce, and the member has been asked to provide the services for both parties during the divorce proceedings.
- In connection with a PFP engagement, a member plans to suggest that the client invest in a business in which he or she has a financial interest.
- A member provides tax or PFP services for several members of a family who may have opposing interests.
- A member has a significant financial interest, is a member of management, or is in a position of influence in a company that is a major competitor of a client for which the member performs management consulting services.
- A member serves on a city's board of tax appeals, which considers matters involving several of the member's tax clients.
- A member has been approached to provide services in connection with the purchase of real estate from a client of the member's firm.
- A member refers a PFP or tax client to an insurance broker or other service provider, which refers clients to the member under an exclusive arrangement to do so.
- A member recommends or refers a client to a service bureau in which the member or partner(s) in the member's firm hold material financial interest(s).

The above examples are not intended to be all-inclusive.

[Replaces previous interpretation 102-2, *Conflicts of Interest*, August 1995, effective August 31, 1995.]

.04 102-3—Obligations of a Member to His or Her Employer's External Accountant. Under rule 102 [ET section 102.01], a member must maintain objectivity and integrity in the performance of a professional service. In dealing with his or her employer's external accountant, a member must be candid and not knowingly misrepresent facts or knowingly fail to disclose material facts. This would include, for example, responding to specific inquiries for which his or her employer's external accountant requests written representation.

[Effective November 30, 1993.]

.05 102-4—Subordination of judgment by a member. Subordination of judgment by a member. Rule 102 [ET section 102.01] prohibits a member from knowingly misrepresenting facts or subordinating his or her judgment when performing professional services. Under this rule, if a member and his or her supervisor have a disagreement or dispute relating to the preparation of financial statements or the recording of transactions, the member should take the following steps to ensure that the situation does not constitute a subordination of judgment:[1]

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[1] 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*. *[Footnote revised, effective for audits of fiscal years beginning on or after December 15, 2010. See PCAOB Release 2010-004.]*

1. The member should consider whether (*a*) the entry or the failure to record a transaction in the records, or (*b*) the financial statement presentation or the nature or omission of disclosure in the financial statements, as proposed by the supervisor, represents the use of an acceptable alternative and does not materially misrepresent the facts. If, after appropriate research or consultation, the member concludes that the matter has authoritative support and/or does not result in a material misrepresentation, the member need do nothing further.
2. If the member concludes that the financial statements or records could be materially misstated, the member should make his or her concerns known to the appropriate higher level(s) of management within the organization (for example, the supervisor's immediate superior, senior management, the audit committee or equivalent, the board of directors, the company's owners). The member should consider documenting his or her understanding of the facts, the accounting principles involved, the application of those principles to the facts, and the parties with whom these matters were discussed.
3. If, after discussing his or her concerns with the appropriate person(s) in the organization, the member concludes that appropriate action was not taken, he or she should consider his or her continuing relationship with the employer. The member also should consider any responsibility that may exist to communicate to third parties, such as regulatory authorities or the employer's (former employer's) external accountant. In this connection, the member may wish to consult with his or her legal counsel.
4. The member should at all times be cognizant of his or her obligations under interpretation 102-3 [ET section 102.04].

[Effective November 30, 1993.]

.06 102-5—Applicability of Rule 102 to Members Performing Educational Service. Educational services (for example, teaching full- or part-time at a university, teaching a continuing professional education course, or engaging in research and scholarship) are professional services as defined in ET section 92.11, and are therefore subject to rule 102 [ET section 102.01]. Rule 102 [ET section 102.01] provides that the member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

[Effective March 31, 1995.]

.07 102-6—Professional services involving client advocacy. A member or a member's firm may be requested by a client—

1. To perform tax or consulting services engagements that involve acting as an advocate for the client.
2. To act as an advocate in support of the client's position on accounting or financial reporting issues, either within the firm or outside the firm with standard setters, regulators, or others.

Services provided or actions taken pursuant to such types of client requests are professional services [ET section 92.11] governed by the Code of Professional Conduct and shall be performed in compliance with Rule 201, *General Standards* [ET section 201.01], Rule 202, *Compliance With Standards* [ET section 202.01], and Rule 203, *Accounting Principles* [ET section 203.01], and interpretations thereof, as applicable. Furthermore, in the performance of any professional service, a member shall comply with rule 102 [ET section 102.01], which

requires maintaining objectivity and integrity and prohibits subordination of judgment to others. When performing professional services requiring independence, a member shall also comply with rule 101 [ET section 101.01] of the Code of Professional Conduct.

Moreover, there is a possibility that some requested professional services involving client advocacy may appear to stretch the bounds of performance standards, may go beyond sound and reasonable professional practice, or may compromise credibility, and thereby pose an unacceptable risk of impairing the reputation of the member and his or her firm with respect to independence, integrity, and objectivity. In such circumstances, the member and the member's firm should consider whether it is appropriate to perform the service.

[Effective August 31, 1995.]

ET Section 191

Ethics Rulings on Independence, Integrity, and Objectivity

1. Acceptance of a Gift

.001 *Question*—Would independence be considered to be impaired if a member accepts a gift or other unusual consideration from a client?

.002 *Answer*—Independence would be considered to be impaired if a *covered* member accepts more than a token gift from a client, even with the knowledge of the member's firm.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

2. Association Membership

.003 *Question*—Would independence be considered to be impaired if a member joined a trade association that is a client of the firm?

.004 *Answer*—Independence would not be considered to be impaired provided the member did not serve as an officer, director, or in any capacity equivalent to that of a member of management.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[3.] Member as Signer or Cosigner of Checks

[.005–.006] [Deleted May 1999]

[4.] Payroll Preparation Services

[.007–.008] [Deleted May 1999]

[5.] Member as Bookkeeper

[.009–.010] [Deleted June 1991]

[6.] Member's Spouse as Accountant of Client

[.011–.012] [Deleted November 2001]

[7.] Member Providing Contract Services

[.013–.014] [Deleted May 1999]

8. Member Providing Advisory Services

.015 *Question*—A member provides extensive advisory services for a client. In that connection, the member attends board meetings, interprets financial statements, forecasts and other analyses, counsels on potential expansion plans and on banking relationships. Would independence be considered to be impaired under these circumstances?

.016 *Answer*—Independence would not be considered to be impaired because the member's role is advisory in nature.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

9. Member as Representative of Creditor's Committee

.017 *Question*—A member performs the following functions for a creditors' committee in control of a debtor corporation which will continue to operate under its existing management subject to extension agreements:

- Signs or co-signs checks issued by the debtor corporation.
- Signs or co-signs purchase orders in excess of established minimum amounts.
- Exercises general supervision to insure compliance with budgetary controls and pricing formulas established by management, with the consent of the creditors, as part of an overall program aimed at the liquidation of deferred indebtedness.

Would independence be considered to be impaired with respect to the debtor corporation?

.018 *Answer*—Independence would be considered to be impaired if *any* partner or professional employee of the firm performed any of the functions described, since these are considered to be management functions.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

10. Member as Legislator

.019 *Question*—A member is an elected legislator in a local government (a city). The city manager, who is responsible for all administrative functions, is also an elected official. Would independence be considered to be impaired with respect to the city?

.020 *Answer*—Independence would be considered to be impaired if *any* partner or professional employee of the firm served as an elected legislator for a city at the same time his or her firm was engaged to perform the city's attest engagement, even though the city manager is an elected official rather than an appointee of the legislature.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

11. Member Designated to Serve as Executor or Trustee

.021 *Question*—A member has been designated to serve as an executor or trustee of the estate of an individual who owns the majority of a client's stock. Would independence be considered to be impaired with respect to the client?

.022 *Answer*—The mere designation of a *covered* member as executor or trustee would not be considered to impair independence, however, if a covered member actually served in such capacity, independence would be considered to be impaired.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

12. Member as Trustee of Charitable Foundation

.023 *Question*—A charitable foundation is the sole beneficiary of the estate of the foundation's deceased organizer. If a member becomes a trustee of the foundation, would independence be considered to be impaired with respect to (1) the foundation or (2) the estate?

.024 *Answer*—If a *covered* member served as trustee of the foundation, independence would be considered to be impaired with respect to both the foundation and the estate.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[13.] Member as Bank Stockholder

[.025–.026] [Deleted November 1993]

14. Member on Board of Federated Fund-Raising Organization

.027 *Question*—A member serves as a director or officer of a United Way or similar federated fund-raising organization (the organization). Certain local charities receive funds from the organization. Would independence be considered to be impaired with respect to such charities?

.028 *Answer*—Independence would be considered to be impaired if *any* partner or professional employee of the firm served as a director or officer of the organization and the organization exercised managerial control over the local charities. (See ethics ruling No. 93 [ET section 191.186–.187] under rule 101 [ET section 101.01] for additional guidance.)

[Replaces previous ruling No. 14, *Member on Board of Directors of United Fund*, April 1991. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[15.] Retired Partner as Director

[.029–.030] [Deleted June 1991]

16. Member on Board of Directors of Nonprofit Social Club

.031 *Question*—Would independence be considered to be impaired if a member served on the board of directors of a nonprofit social club?

.032 *Answer*—Independence would be considered to be impaired if *any* partner or professional employee of the firm served on the board of directors since the board has ultimate responsibility for the club's affairs.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

17. Member of Social Club

.033 *Question*—Would independence be considered to be impaired if a member belongs to a social club (for example, country club, tennis club) that requires him or her to acquire a pro rata share of the club's equity or debt securities?

.034 *Answer*—As long as membership in a club is essentially a social matter, a *covered* member's association with the club would not impair independence because such equity or debt ownership would not be considered to be a direct financial interest within the meaning of rule 101 [ET section 101.01]. Also see interpretation 101-1.C [ET section 101.02].

[Replaces previous ruling No. 17, *Member as Stockholder in Country Club*, February 1991. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[18.] Member as City Council Chairman

[.035–.036] [Deleted June 1991]

19. Member on Deferred Compensation Committee

.037 *Question*—Would independence be considered to be impaired if a member served on a committee that administers a client's deferred compensation program?

.038 *Answer*—Independence would be considered to be impaired if *any* partner or professional employee of the firm served on the committee since such service constitutes participation in the client's management functions. The partner or professional employee could however render consulting assistance without joining the committee.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

20. Member Serving on Governmental Advisory Unit

.039 *Question*—A member serves on a citizens' committee which is studying possible changes in the form of a county government that the firm audits. The member also serves on a committee appointed to study the financial status of a state. Would independence be considered to be impaired with respect to a county in that state?

.040 *Answer*—Independence would not be considered to be impaired with respect to the county through the member's service on either committee.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

21. Member as Director and Auditor of an Entity's Profit Sharing and Retirement Trust

.041 *Question*—A member serves in the dual capacity of director of an entity and auditor of the financial statements of that entity's profit sharing and retirement trust (the trust). Would independence be considered to be impaired with respect to the trust?

.042 *Answer*—Service as director of an entity constitutes participation in management functions that affect the entity's trust. Accordingly, independence would be considered to be impaired if *any* partner or professional of the firm served in such capacity.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[22.] Family Relationship, Brother

[.043–.044] [Deleted June 1991]

[23.] Family Relationship, Uncle by Marriage

[.045–.046] [Deleted June 1991]

[24.] Family Relationship, Father

[.047–.048] [Deleted June 1991]

[25.] Family Relationship, Son

[.049–.050] [Deleted June 1991]

[26.] Family Relationship, Son

[.051–.052] [Deleted June 1991]

[27.] Family Relationship, Spouse as Trustee

[.053–.054] [Deleted June 1991]

[28.] Cash Account With Brokerage Client

[.055–.056] [Superseded by ethics ruling No. 59.]

29. Member as Bondholder

.057 *Question*—Would independence be considered to be impaired if a member owned an immaterial amount of a municipal authority's outstanding bonds?

.058 *Answer*—Ownership of a client's bonds constitute a loan to that client. Accordingly, if a *covered* member owned such bonds, independence would be considered to be impaired.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[30.] Financial Interest by Employee

[.059–.060] [Deleted July 1979]

31. Performance of Services for Common Interest Realty Associations (CIRAs), Including Cooperatives, Condominium Associations, Planned Unit Developments, Homeowners Associations, and Timeshare Developments

.061 *Question*—A member belongs to a common interest realty association (CIRA) as the result of the ownership or lease of real estate. Would independence be considered to be impaired with respect to the CIRA?

.062 *Answer*—Independence would be considered to be impaired if a *covered* member was a member of a CIRA unless all of the following conditions are met:

a. The CIRA performs functions similar to local governments, such as public safety, road maintenance, and utilities.

b. The covered member's annual assessment is not material to either the covered member or the CIRA's operating budgeted assessments.

c. The liquidation of the CIRA or the sale of common assets would not result in a distribution to the covered member.

d. The CIRA's creditors would not have recourse to the covered member's assets if the CIRA became insolvent.

Also see interpretation 101-1.C [ET section 101.02] for additional restrictions related to associations with a client.

If the member has a relationship with a real estate developer or management company that is associated with the CIRA, see interpretation 102-2 [ET section 102.03] for guidance.

[Revised, effective May 31, 1998, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[32.] Mortgage Loan to Member's Corporation

[.063–.064] [Deleted December 1991]

[33.] Member as Participant in Employee Benefit Plan

[.065–.066] [Deleted May 1998]

[34.] Member as Auditor of Common Trust Funds

[.067–.068] [Deleted February 1991]

35. Stockholder in Mutual Funds

.069 *Question*—A member owns shares in a non-regulated mutual investment fund (the fund) which holds shares of stock in a client. Would independence be considered to be impaired with respect to the client whose stock is held by the fund?

.070 *Answer*—Client securities held by the fund represent indirect financial interests. Accordingly, if a *covered* member has such an indirect financial interest, which is material to the covered member, independence would be considered to be impaired. In addition, if *any* partner or professional employee in

the firm has significant influence over the fund, independence would be considered to be impaired.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

36. Participant in Investment Club

.071 *Question*—A member participates in an investment club. Would independence be considered to be impaired with respect to a client in which the investment club holds shares?

.072 *Answer*—Independence would be considered to be impaired if a *covered* member owned stock in a client through an investment club as such holdings would be deemed to be a direct financial interest. Accordingly, any of the club's investments in a client would be deemed to impair independence regardless of materiality of the investment to the covered member's net worth.

See interpretation 101-1.B [ET section 101.02] for additional restrictions relating to all partners and professionals of the firm.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[37.] Retired Partners as Co-Trustee

[.073–.074] [Deleted November 1980]

38. Member as Co-Fiduciary With Client Bank

.075 *Question*—A member serves with a client bank in a co-fiduciary capacity with respect to an estate or trust. Would independence be considered to be impaired with respect to the bank or the bank's trust department?

.076 *Answer*—Independence would not be considered to be impaired provided the assets in the estate or trust were not material to the total assets of the bank and/or the bank's trust department.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[39.] Member as Officially Appointed Stock Transfer Agent or Registrar

[.077–.078] [Deleted May 1999]

[40.] Controller Entering Public Practice

[.079–.080] [Deleted June 1979]

41. Financial Services Company Client Has Custody of a Member's Assets

.081 *Question*—A financial services company client (for example, insurance company, investment adviser, broker-dealer, bank, or other depository institution) has custody of a member's assets (other than depository accounts),

including retirement plan assets. Would independence be considered to be impaired?

.082 *Answer*—If a covered member's assets were held by a financial services company client, independence would not be considered to be impaired provided the services were rendered under the company's normal terms, procedures, and requirements and any of the covered member's assets subject to the risk of loss were immaterial to the covered member's net worth. Risk of loss may include losses arising from the bankruptcy of or defalcation by the client but would exclude losses due to a market decline in the value of the assets. When considering the materiality of assets subject to the risk of loss, the covered member should consider the following:

- Protection provided by state or federal regulators (for example, state insurance funds)
- Private insurance or other forms of protection (for example, the Securities Investor Protection Corporation) obtained by the financial services company to protect the assets
- Protection from creditors (for example, assets held in a pooled separate account)

For guidance dealing with depository accounts, see ethics ruling No. 70 [ET section 191.140 and .141].

[Replaces previous ruling No. 41, *Member as Auditor of Mutual Insurance Company*, November, 1990. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Revised, effective March 31, 2003, by the Professional Ethics Executive Committee.]

[42.] Member as Life Insurance Policy Holder

[.083–.084] [Deleted April 1991]

[43.] Member's Employee as Treasurer of a Client

[.085–.086] [Deleted June 1991]

[44.] Past Due Billings

[.087–.088] [Superseded by ethics ruling No. 52.]

[45.] Past Due Fees: Client in Bankruptcy

[.089–.090] [Deleted November 1990]

[46.] Member as General Counsel

[.091–.092] [Superseded by ethics ruling No. 51.]

[47.] Member as Auditor of Mutual Fund and Shareholder of Investment Advisor/Manager

[.093–.094] [Deleted February 1991]

48. Faculty Member as Auditor of a Student Fund

.095 *Question*—A full or part-time faculty member employed by a university is asked to audit the financial statements of the Student Senate Fund. The university:

1. Acts as a collection agent for student fees and remits them to the Student Senate.
2. Requires that a university administrator approve and sign Student Senate checks.

Would independence be considered to be impaired under these circumstances?

.096 *Answer*—Independence would be considered to be impaired with respect to the Student Senate Fund if *any* partner or professional employee (individual) performed the functions described since the individual would be auditing several of the management functions performed by the university, the individual's employer.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[49.] Investor and Investee Companies

[.097–.098] [Superseded by interpretation 101-8.]

[50.] Family Relationship, Brother-in-Law

[.099–.100] [Deleted June 1983]

[51.] Member Providing Legal Services

[.101–.102] [Deleted May 1999]

52. Unpaid Fees

.103 *Question*—A client of the member's firm has not paid fees for previously rendered professional services. Would independence be considered to be impaired for the current year?

.104 *Answer*—Independence is considered to be impaired if, when the report on the client's current year is issued, billed or unbilled fees, or a note receivable arising from such fees, remain unpaid for any professional services provided more than one year prior to the date of the report.

This ruling does not apply to fees outstanding from a client in bankruptcy.

[Replaces previous ruling No. 52, *Past Due Fees*, November 1990. Revised, effective November 30, 1997, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[53.] Member as Auditor of Employee Benefit Plan and Sponsoring Company

[.105–.106] [Deleted June 1991]

[54.] Member Providing Appraisal, Valuation, or Actuarial Services

[.107–.108] [Deleted May 1999]

[55.] Independence During Systems Implementation

[.109–.110] [Deleted May 1999]

[56.] Executive Search

[.111–.112] [Deleted May 1999]

[57.] MAS Engagement to Evaluate Service Bureaus

[.113–.114] [Deleted August 1995]

[58.] Member as Lessor

[.115–.116] [Deleted May 1998]

[59.] Account With Brokerage Client

[.117–.118] [Deleted November 1987]

60. Employee Benefit Plans—Member's Relationships With Participating Employer

.119 *Question*—A member has been asked to audit the financial statements of an employee benefit plan ("the plan") that may have one or more participating employer(s). Would independence be considered to be impaired with respect to the plan if the member had financial or other relationships with a participating employer(s)?

.120 *Answer*—Independence would be considered to be impaired with respect to the plan if *any* partner or professional employee of the firm had significant influence over such employer, was in a key position with the employer, or was associated with the employer as a promoter, underwriter, or voting trustee.

When auditing plans subject to the Employee Retirement Income Security Act of 1974 (ERISA), Department of Labor (DOL) regulations must be followed. [1]

[Replaces previous ruling No. 60, *Employee Benefit Plans—Member's Relationships With Participating Employer(s)*, November 1993. Revised, effective November 30, 2001, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[61.] Participation of Member's Spouse in Client's Stock Ownership Plans (Including an ESOP)

[.121–.122] [Deleted May 1998]

[62.] Member and Client Are Limited Partners in a Limited Partnership

[.123–.124] [Deleted April 1991]

[63.] Review of Prospective Financial Information—Member's Independence of Promotors

[.125–.127] [Deleted August 1992]

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[1] Currently, DOL regulations are more restrictive than the position taken in this ruling.

64. Member Serves on Board of Organization for Which Client Raises Funds

.128 *Question*—A member serves on the board of directors of an organization. A fund-raising foundation functions solely to raise funds for that organization. Would independence be considered to be impaired with respect to the fund-raising foundation?

.129 *Answer*—Independence would be considered to be impaired with respect to the fund-raising foundation if *any* partner or professional employee of the firm served on the organization's board of directors. However, if the directorship were clearly honorary (in accordance with ET section 101.06, *Honorary directorships and trusteeships of not-for-profit organization*), independence would not be considered to be impaired.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

65. Use of the CPA Designation by Member Not in Public Practice

.130 *Question*—A member who is not in public practice wishes to use his or her CPA designation in connection with financial statements and correspondence of the member's employer. The member also wants to use the CPA designation along with employment title on business cards. Is it permissible for the member to use the CPA designation in these manners?

.131 *Answer*—Yes. However, if the member uses the CPA designation in a manner to imply that he or she is independent of the employer, the member would be knowingly misrepresenting facts in violation of rule 102 [ET section 102.01]. Therefore, it is advisable that in any transmittal within which the member uses his or her CPA designation, he or she clearly indicate the employment title. In addition, if the member states affirmatively in any transmittal that a financial statement is presented in conformity with generally accepted accounting principles, the member is subject to rule 203 [ET section 203.01].

[Replaces previous ruling No. 65, *Use of the CPA Designation by Member Not in Public Practice*, February 1996, effective February 29, 1996.]

66. Member's Retirement or Savings Plan Has Financial Interest in Client

.132 *Question*—A member's retirement or savings plan has a financial interest in a client. Would independence be considered to be impaired?

.133 *Answer*—Any direct or material indirect financial interest in a client held through a retirement or savings plan would be considered to be a direct or material indirect financial interest in the client. Accordingly, if a *covered* member had such a financial interest, independence would be considered to be impaired.

See interpretation 101-1.B [ET section 101.02] for additional restrictions relating to all partners and professionals of the firm.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

67. Servicing of Loan

.134 *Question*—Would the mere servicing of a loan by a client financial institution impair independence with respect to the client?

.135 *Answer*—No.

[Replaces previous ruling No. 67, *Servicing of Loan*, November 1993. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

68. Blind Trust

.136 *Question*—Would independence be considered to be impaired if a member transferred a direct financial interest in a client into a blind trust?

.137 *Answer*—Independence would be considered impaired if a *covered* member had a direct financial interest in a client, whether or not the interest was placed in a blind trust. Further, the covered member should ensure that any blind trust for which he or she is a beneficiary does not hold a direct or material indirect financial interest in any clients with respect to which he or she is a covered member.

[Revised, effective June 30, 1990, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

69. Investment With a General Partner

.138 *Question*—A private, closely held entity is the general partner and controls (as defined in Generally Accepted Accounting Principles) limited partnership A. The member has a material financial interest in limited partnership A. The member's firm has been asked to perform an attest engagement for a new limited partnership (B), which has the same general partner as limited partnership A. Would independence be considered to be impaired with respect to limited partnership B?

.139 *Answer*—Because the general partner has control over limited partnership A, the *covered* member would be considered to have a joint closely held investment with the general partner, who has significant influence over limited partnership B, the proposed client. Accordingly, independence would be considered to be impaired with respect to limited partnership B if the covered member had a material investment in limited partnership A.

[Replaces previous ruling No. 69, *Joint Investment With a Promoter and/or General Partner*, April 1991, effective April 30, 1991. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

70. Member's Depository Relationship With Client Financial Institution

.140 *Question*—A member maintains checking or savings accounts, certificates of deposit, or money market accounts at a client financial institution. Would these depository relationships impair independence?

.141 *Answer*—If an individual is a covered member, independence would not be considered to be impaired provided that—

- The checking accounts, savings accounts, certificates of deposit, or money market accounts were fully insured by the appropriate state or federal government deposit insurance agencies or by any other insurer; or

- The uninsured amounts, in the aggregate, were not material to the net worth of the covered member. (When insured amounts were considered material, independence would not be considered impaired provided the uninsured balance was reduced to an immaterial amount no later than 30 days from the date the uninsured amount becomes material.)

A firm's depository relationship would not impair its independence provided that the likelihood of the financial institution experiencing financial difficulties was considered to be remote.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Revised, effective March 31, 2003, by the Professional Ethics Executive Committee.]

71. Use of Nonindependent CPA Firm on an Engagement

.142 *Question*—Firm A is not independent with respect to a client. Partners or professional employees of Firm A are participating on Firm B's attest engagement team for that client. Would Firm B's independence be considered to be impaired?

.143 *Answer*—Yes. The use by Firm B of partners or professional employees from Firm A as part of the attest engagement team would impair Firm B's independence with respect to that engagement.

However, use of the work of such individuals in a manner similar to internal auditors is permissible provided that there is compliance with the Statements on Auditing Standards. Applicable literature contained in the Statements on Auditing Standards should be consulted.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

72. Member on Advisory Board of Client

.144 *Question*—Would service on a client's advisory board impair independence?

.145 *Answer*—Independence would be considered to be impaired if *any* partner or professional employee of the firm served on the advisory board unless all the following criteria are met: (1) the responsibilities of the advisory board are in fact advisory in nature; (2) the advisory board has no authority to make nor does it appear to make management decisions on behalf of the client; and (3) the advisory board and those having authority to make management decisions (including the board of directors or its equivalent) are distinct groups with minimal, if any, common membership.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[73.] Meaning of the Period of a Professional Engagement

[.146–.147] [Deleted February 1998]

74. Audits, Reviews, or Compilations and a Lack of Independence

.148 *Question*—If a member or his or her firm is not independent with respect to a client, is it permissible to issue an audit, review, or compilation report for that client?

.149 *Answer*—A member or his or her firm may not issue an audit or review report if not independent of the client. A compilation report may be issued provided that the report specifically discloses the lack of independence without giving reasons for the impairment.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

75. Membership in Client Credit Union

.150 *Question*—Does membership in a client credit union impair independence?

.151 *Answer*—A *covered* member's association with a client credit union would not impair independence provided all of the following criteria are met:

1. The covered member individually qualifies to join the credit union (other than by virtue of the professional services provided to the client).
2. Any loans from the credit union to the covered member meet the conditions specified in interpretation 101-1.A.4 [ET section 101.02] and are made under normal lending procedures, terms, and requirements (see interpretation 101-5 [ET section 101.07]).
3. Any deposits with the credit union meet the conditions specified in ruling No. 70 [ET section 191.140–.141] under rule 101 [ET section 101.01].

Partners and professional employees may be subject to additional restrictions as described in interpretation 101-1.B [ET section 101.02].

[Effective February 28, 1992, earlier application is encouraged. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[76.] Guarantee of Loan

[.152–.153] [Deleted December 1991]

[77.] Individual Considering or Accepting Employment With the Client

[.154–.155] [Deleted April 2003]

[78.] Service on Governmental Board

[.156–.157] [Deleted August 1995]

79. Member's Investment in a Partnership That Invests in Client

.158 *Question*—Would independence be considered to be impaired if a member had a direct financial interest in a partnership that invests in a client?

.159 *Answer*—If a *covered* member is a general partner, or functions in a capacity similar to that of a general partner, in a partnership that invests in a client, the covered member is deemed to have a direct financial interest in the client. Independence is considered to be impaired.

If a *covered* member is a limited partner in a partnership that invests in a client, the covered member is considered to have an indirect financial interest in the client. Independence would be considered to be impaired if the indirect financial interest is material to the covered member's net worth.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[80.] The Meaning of a Joint Closely Held Business Investment

[.160–.161] [Deleted November 2001]

81. Member's Investment in a Limited Partnership

.162 *Question*—A member is a limited partner in a limited partnership (LP), including a master limited partnership. A client is a general partner in the same LP. Is independence considered to be impaired with respect to (1) the LP, (2) the client, and (3) any subsidiaries of the LP?

.163 *Answer*—**1.** A *covered* member's limited partnership interest in the LP is a direct financial interest in the LP that would impair independence under interpretation 101-1.A.1 [ET section 101.02].

2. The LP is an investee of the client because the client is a general partner in the LP. Therefore, under interpretation 101-8 [ET section 101.10], if the investment in the LP were material to the client, a *covered* member's financial interest in the LP would impair independence. However, if the client's financial interest in the LP were not material to the client, a *covered* member's immaterial financial interest in the LP would not impair independence.

3. If the *covered* member is a limited partner in the LP, the covered member is considered to have an indirect financial interest in all subsidiaries of the LP. If the indirect financial interest in the subsidiaries were material to the covered member, independence would be considered to be impaired with respect to those subsidiaries under interpretation 101-1.A.1 [ET section 101.02].

If the covered member or client general partner, individually or together can control the LP, the LP would be considered a joint closely held investment under ET section 92.16.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

82. Campaign Treasurer

.164 *Question*—A member serves as the campaign treasurer of a mayoral candidate. Would independence be considered to be impaired with respect to (1) the political party with which the candidate is associated, (2) the municipality of which the candidate may become mayor, or (3) the campaign organization?

.165 *Answer*—Independence would not be considered to be impaired with respect to the political party or municipality. However, if *any* partner or professional employee of the firm served as campaign treasurer, independence would be considered to be impaired with respect to the campaign organization.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[83.] Member on Board of Component Unit and Auditor of Oversight Entity

[.166–.167] [Deleted January 1996]

[84.] Member on Board of Material Component Unit and Auditor of Another Material Component Unit

[.168–.169] [Deleted January 1996]

85. Bank Director

.170 *Question*—May a member in public practice serve as a director of a bank?

.171 *Answer*—Yes; however, before accepting a bank directorship, the member should carefully consider the implications of such service if the member has clients that are customers of the bank.

These implications fall into two categories:

a. Confidential Client Information—Rule 301 [ET section 301.01] provides that a member in public practice shall not disclose any confidential client information without the specific consent of the client. This ethical requirement applies even though failure to disclose information may constitute a breach of the member's fiduciary responsibility as a director.

b. Conflicts of Interest—Interpretation 102-2 [ET section 102.03] provides that a conflict of interest may occur if a member performs a professional service (including service as a director) and the member or his or her firm has a relationship with another entity that could, in the member's professional judgment, be viewed by appropriate parties as impairing the member's objectivity. If the member believes that the professional service can be performed with objectivity and the relationship is disclosed to and consent is obtained from all appropriate parties, performance of the service shall not be prohibited.

In view of the above factors, it is generally not desirable for a member in public practice to accept a position as bank director where the member's clients are likely to engage in significant transactions with the bank. If a member is engaged in public practice, the member should avoid the high probability of a conflict of interest and the appearance that the member's fiduciary obligations and responsibilities to the bank may conflict with or interfere with the member's ability to serve the client's interest objectively and in complete confidence.

The general knowledge and experience of CPAs in public practice may be very helpful to a bank in formulating policy matters and making business decisions; however, in most instances, it would be more appropriate for the member as part of the member's public practice to serve as a consultant to the bank's board. Under such an arrangement, the member could limit activities to those which did not involve conflicts of interest or confidentiality problems.

[86.] Partially Secured Loans

[.172–.173] [Deleted February 1998]

[87.] Loan Commitment or Line of Credit

[.174–.175] [Deleted February 1998]

[88.] Loans to Partnership in Which Members are Limited Partners

[.176–.177] [Deleted February 1998]

[89.] Loan to Partnership in Which Members are General Partners

[.178–.179] [Deleted February 1998]

[90.] Credit Card Balances and Cash Advances

[.180–.181] [Deleted February 1998]

91. Member Leasing Property to or From a Client

.182 *Question*—Would independence be considered to be impaired if a member leased property to or from a client?

.183 *Answer*—Independence would not be considered to be impaired if the lease meets the criteria of an operating lease (as described in Generally Accepted Accounting Principles), the terms and conditions set forth in the lease agreement are comparable with other leases of a similar nature, and all amounts are paid in accordance with the terms of the lease.

Independence would be considered to be impaired if a *covered* member had a lease that meets the criteria of a capital lease (as described in Generally Accepted Accounting Principles) unless the lease is in compliance with interpretations 101-1.A.4 [ET section 101.02] and 101-5 [ET section 101.07], because the lease would be considered to be a loan to or from the client.

[Revised, effective May 31, 1998, by the Professional Ethics Executive Committee. Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

92. Joint Interest in Vacation Home

.184 *Question*—A member has a joint interest in a vacation home with a client (or one of the client's officers or directors, or any owner who has the ability to exercise significant influence over the client). Would the vacation home constitute a "joint closely held investment" as defined in ET section 92.16?

.185 *Answer*—Yes. The vacation home, even if solely intended for the personal use of the owners, would be considered a joint closely held investment as defined in ET section 92.16 if it meets the criteria described in the aforementioned definition.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

93. Service on Board of Directors of Federated Fund-Raising Organization

.186 *Question*—A member serves as a director or officer of a local United Way or similar organization that operates as a federated fund-raising organization from which local charities receive funds. Some of those charities are clients of the member's firm. Does the member have a conflict of interest under rule 102 [ET section 102.01]?

.187 *Answer*—Interpretation 102-2 [ET section 102.03] provides that a conflict of interest may occur if a member performs a professional service for a client and the member or his or her firm has a relationship with another entity that could, in the member's professional judgment, be viewed by the client or other appropriate parties as impairing the member's objectivity. If the member believes that the professional service can be performed with objectivity and the relationship is disclosed to and consent is obtained from the appropriate parties, performance of the service shall not be prohibited. (If the service being provided is an attest engagement, consult ethics ruling No. 14 [ET section 191.027-.028] under rule 101 [ET section 101.01]).

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

94. Indemnification Clause in Engagement Letters

.188 *Question*—A member or his or her firm proposes to include in engagement letters a clause that provides that the client would release, indemnify, defend, and hold the member (and his or her partners, heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management. Would inclusion of such an indemnification clause in engagement letters impair independence?

.189 *Answer*—No.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

95. Agreement With Attest Client to Use ADR Techniques

.190 *Question*—Alternative dispute resolution (ADR) techniques are used to resolve disputes (in lieu of litigation) relating to past services, but are not used as a substitute for the exercise of professional judgment for current services. Would a predispute agreement to use ADR techniques between a member or his or her firm and a client cause independence to be impaired?

.191 *Answer*—No. Such an agreement would not cause independence to be impaired since the member (or the firm) and the client would not be in threatened or actual positions of material adverse interests by reason of threatened or actual litigation.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

96. Commencement of ADR Proceeding

.192 *Question*—Would the commencement of an alternative dispute resolution (ADR) proceeding impair independence?

.193 *Answer*—Except as stated in the next sentence, independence would not be considered to be impaired because many of the ADR techniques designed to facilitate negotiation and the actual conduct of those negotiations do not place the member or his or her firm and the client in threatened or actual positions of material adverse interests. Nevertheless, if a *covered* member and the client are in a position of material adverse interests because the ADR proceedings are sufficiently similar to litigation, ethics interpretation 101-6 [ET section 101.08] should be applied. Such a position would exist if binding arbitration were used.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

[97.] Performance of Certain Extended Audit Services

[.194–.195] [Deleted August 1996]

98. Member's Loan From a Nonclient Subsidiary or Parent of an Attest Client

.196 *Question*—A member has obtained a loan from a nonclient. The member's firm performs an attest engagement for the parent or a subsidiary of the nonclient. Does the loan from the nonclient subsidiary or parent impair independence?

.197 *Answer*—A *covered* member's loan that is not a "grandfathered" or "permitted" loan under interpretation 101-5 [ET section 101.07] from a nonclient subsidiary would impair independence with respect to the client parent. However, a loan from a nonclient parent would not impair independence with respect to the client subsidiary as long as the subsidiary is not material to its parent.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

99. Member Providing Services for Company Executives

.198 *Question*—A member has been approached by a company, for which he or she may or may not perform other professional services, to provide personal financial planning or tax services for its executives. The executives are aware of the company's relationship with the member, if any, and have also consented to the arrangement. The performance of the services could result in the member recommending to the executives actions that may be adverse to the company. What rules of conduct should the member consider before accepting and during the performance of the engagement?

.199 *Answer*—Before accepting and during the performance of the engagement, the member should consider the applicability of Rule 102, *Integrity and Objectivity* [ET section 102.01]. If the member believes that he or she can perform the personal financial planning or tax services with objectivity, the member would not be prohibited from accepting the engagement. The member should also consider informing the company and the executives of possible results of the engagement. During the performance of the services, the member should consider his or her professional responsibility to the clients (that is, the company and the executives) under Rule 301, *Confidential Client Information* [ET section 301.01].

100. Actions Permitted When Independence Is Impaired

.200 *Question*—If a member or a member's firm (member) was independent when its report was initially issued, may the member re-sign the report or consent to its use at a later date when his or her independence is considered to be impaired?

.201 *Answer*—Yes. A member may re-sign the report or consent to its use at a later date when his or her independence is considered to be impaired, provided that no "post-audit work" is performed by the member during the period of impairment. The term "post-audit work," in this context, does not include inquiries of successor auditors, reading of subsequent financial statements, or such procedures as may be necessary to assess the effect of subsequently discovered facts on the financial statements covered by the member's previously issued report.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

101. Client Advocacy and Expert Witness Services

.202 *Question*—Would the performance of expert witness services be considered as acting as an advocate for a client as discussed in interpretation 102-6 [ET section 102.07]?

.203 *Answer*—No. A member serving as an expert witness does not serve as an advocate but as someone with specialized knowledge, training, and experience in a particular area who should arrive at and present positions objectively.

102. Indemnification of a Client

.204 *Question*—As a condition to retaining a member or his or her firm to perform an attest engagement, a client or prospective client requests that the member (or the firm) enter into an agreement providing, among other things, that the member (or the firm) indemnify the client for damages, losses, or costs arising from lawsuits, claims, or settlements that relate, directly or indirectly, to client acts. Would entering into such an agreement impair independence?

.205 *Answer*—Yes. Such an agreement would impair independence under interpretation 101-1.A [ET section 101.02] and interpretation 101-1.C [ET section 101.02].

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

103. Attest Report on Internal Controls

.206 *Question*—If a member or his or her firm provides extended audit services for a client in compliance with interpretation 101-13 [ET section 101.15], would the firm be considered to be independent in the performance of an attestation engagement to report on the client's assertion regarding the effectiveness of its internal control over financial reporting?

.207 *Answer*—Independence would not be considered to be impaired with respect to the issuance of such a report if both of the following conditions are met:

1. Management has assumed responsibility to establish and maintain internal control.
2. Management does not rely on the firm's work as the primary basis for its assertion and accordingly has (*a*) evaluated the results of its ongoing monitoring procedures built into the normal recurring activities of the entity (including regular management and supervisory activities) and (*b*) evaluated the findings and results of the firm's work and other separate evaluations of controls, if any.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

104. Operational Auditing Services

.208 *Question*—As part of an extended audit engagement, a member or his or her firm reviews certain of the client's business processes, as selected by the client, for how well they function, their efficiency, or their effectiveness. For example, a member (or the firm) may assess whether performance is in compliance with management's policies and procedures, to identify opportunities for improvement, and to develop recommendations for improvement or further action for management consideration and decision making. Would independence be considered to be impaired in performing such services?

.209 *Answer*—Independence would not be considered to be impaired provided that during the course of the review the member (and other members of his or her firm) is not employed by the client and does not act or appear to act in any capacity equivalent to that of a member of client management. The decision as to whether any of the member's (or the firm's) recommendations will be implemented must rest entirely with management.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

105. Frequency of Performance of Extended Audit Procedures

.210 *Question*—In providing extended audit services, would the frequency with which a member or his or her firm performs an audit procedure impair independence?

.211 *Answer*—Independence would not be considered to be impaired provided that the member's (or the firm's) activities have been limited in a manner consistent with interpretation 101-13 [ET section 101.15] and the procedures performed constituted separate evaluations of the effectiveness of the ongoing control and monitoring activities/procedures that are built into the client's normal recurring activities.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

106. Member Has Significant Influence Over an Entity That Has Significant Influence Over a Client

.212 *Question*—Would independence be considered to be impaired if a member or his or her firm had significant influence, as defined in ET section 92.27, over an entity that has significant influence over a client?

.213 *Answer*—Independence would be considered to be impaired if *any* partner or professional of the firm had significant influence over an entity that has significant influence over a client. By having such influence over the nonclient entity, the partner or professional employee would also be considered to have significant influence over the client.

See interpretation 101-8 [ET section 101.10] for further guidance.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

107. Participation in Health and Welfare Plan Sponsored by Client

.214 *Question*—A member participates in or receives benefits from a health and welfare plan (the "plan") sponsored by a client. Would independence be considered to be impaired with respect to the client sponsor or the plan?

.215 *Answer*—A *covered* member's participation in a plan sponsored by a client would impair independence with respect to the client sponsor and the plan. However, if the covered member's participation in the plan, or benefits received thereunder, arises as a result of the permitted employment of the covered member's immediate family in accordance with interpretation 101-1 [ET section 101.02], independence would not be considered to be impaired provided that the plan is normally offered to all employees in equivalent employment positions.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Revised, November 2002, by the Professional Ethics Executive Committee.]

[108.] Participation of Member, Spouse or Dependent in Retirement, Savings, or Similar Plan Sponsored by, or That Invests in, Client

[.216–.217] [Deleted November 2001]

109. Member's Investment in Financial Services Products That Invest in Clients

.218 *Question*—Amounts contributed by a member or a member's firm (member) for investment purposes, including retirement plans, are invested or managed by a nonclient financial services company that offers financial services products, for example, insurance contracts and other investment arrangements, which allow the member to direct his or her investment into debt or equity securities. Under what circumstances would independence be considered to be impaired?

.219 *Answer*— If a *covered* member is able to direct and does direct his or her investment through a financial services product into a client, independence would be considered to be impaired because such investment is considered to be a direct financial interest in the client. If the covered member does not exercise his or her ability to direct the investment but the financial services product were to invest in a client, such investment would be a direct financial interest in the client and independence would be considered to be impaired.

If the covered member is not able to direct the investment and the financial services product invests in a client, the covered member is considered to have

an indirect financial interest in the client. Independence would be considered to be impaired if the indirect financial interest becomes material to the covered member. (See ethics ruling No. 35 under rule 101 [ET section 191.069–.070] for additional guidance with respect to investments in mutual funds.)

Further, an investment in a financial services product that invests only in clients with respect to which an individual is considered to be a covered member would be considered to be a direct financial interest in such client, and independence would be considered to be impaired.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

110. Member is Connected With an Entity That Has a Loan to or From a Client

.220 *Question*—A member is associated with an entity as an officer, director, or a shareholder who is able to exercise significant influence over an entity. That entity has a loan to or from a client of the member's firm. Would independence be considered to be impaired with respect to the client?

.221 *Answer*—If a *covered* member has control over the entity (as defined in Generally Accepted Accounting Principles) the existence of a loan to or from the client would impair independence unless the loan from the client is specifically permitted under interpretation 101-5 [ET section 101.07].

If *any* partner or professional employee of the firm is connected with the entity as an officer, director, or shareholder who is able to exercise significant influence over the entity, but is unable to control the entity, he or she should consider interpretation 102-2 [ET section 102.03]. Interpretation 102-2 provides that a conflict of interest may occur if a member performs a professional service for a client and the member or his or her firm has a relationship with another entity that could, in the member's professional judgment, be viewed by the client or other appropriate parties as impairing the member's objectivity. If the member believes that the professional service can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client and other appropriate parties, the rule shall not operate to prohibit the performance of the professional service.

When making the decision as to whether to perform a professional service and in making disclosure to the appropriate parties, the member should consider Rule 301, *Confidential Client Information* [ET section 301.01].

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

111. Employee Benefit Plan Sponsored by Client

.222 *Question*—A member or his or her firm provides asset management or investment services that may include having custody of assets, performing management functions, or making management decisions for an employee benefit plan (the plan) sponsored by a client. Would independence be considered to be impaired with respect to the plan and the client sponsor?

.223 *Answer*—The performance of investment management or custodial services for a plan would be considered to impair independence with respect to the plan. Independence would also be considered to be impaired with respect to the client sponsor of a defined benefit plan if the assets under management or in the custody of the member are material to the plan or the client sponsor.

Independence would not be considered to be impaired with respect to the client sponsor of a defined contribution plan provided the member does not make any management decisions or perform management functions on behalf of the client sponsor or have custody of the sponsor's assets.

[Revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]

ET TOPICAL INDEX

References are to ET section and paragraph numbers.

D

E

F

G

H

I

N

O

P

R

S

T

U

V

ISB
INDEPENDENCE STANDARDS BOARD

TABLE OF CONTENTS

Independence Standards Board Standard No. 1

Independence Discussions with Audit Committees

[This section was superseded, effective September 30, 2008, by Rule 3526. See PCAOB Release No. 2008-003.]

Independence Standards Board Standard No. 2

Certain Independence Implications of Audits of Mutual Funds and Related Entities

December 1999

As Amended—July 2000

SUMMARY

This Independence Standard, as described in more detail herein:

A. Requires the audit firm, certain of its retirement plans, the audit engagement team and those in a position to influence the audit, when the firm is auditing mutual funds, to be independent of all sister funds and all related non-fund entities. In addition, when auditing a related non-fund entity, independence would be required by the same entities and individuals of all funds in the mutual fund complex.

B. Permits:

i. Direct investment in non-audit client sister funds by all other partners and employees of the firm.

ii. Spouses and dependents of partners, other than of the audit engagement team and in a position to influence the audit, to invest through an employee benefit plan in mutual funds that are audit clients.

C. Is effective with respect to audits of financial statements for periods beginning 60 days after existing rules of the SEC are modified to remove conflicts with the Standard. The SEC has proposed rulemaking with regard to its independence rules, including consideration of the provisions of this Standard. Notification of relevant changes by the SEC will be posted to the ISB's website at www.cpaindependence.org when confirmation is received by the Board.

(Please note that terms appearing for the first time in **bold** type are defined in paragraph 6.)

STANDARD

Applicability

1. This Standard applies to the determination of auditor independence with respect to audits of **mutual funds** and related entities which are subject to the independence requirements of the SEC.

Standard

2. The auditing firm will not be considered independent of all of the entities within the **mutual fund complex** if the partners in the firm, either individually or collectively, have significant influence over any entity in that complex.

3. In other situations:

a. The auditing firm itself, and its retirement plans *(other than self-directed defined contribution employee benefit plans, such as 401(k) plans)*, and

b. The audit engagement team and **those in a position to influence the audit**, when the firm is auditing:

i. A *fund*, must be independent of all ***sister funds***.

ii. A *related* ***non-fund entity***, must be independent of all *related non-client funds*—that is, all funds in the complex.[1]

iii. One or more *funds*, must be independent of all *related non-fund entities* in the mutual fund complex.[2]

4. A spouse, cohabitant or dependent of a partner not on the audit engagement team, and not in a position to influence the audit, is permitted to invest through an employer-sponsored benefit plan in mutual funds that are audit clients of the firm.

Effective Date

5. The above requirements are effective with respect to audits of financial statements for periods beginning 60 days after existing rules of the SEC are modified to remove conflicts with the Standard. The SEC has proposed rulemaking with regard to its independence rules, including consideration of the provisions of this Standard. Notification of relevant changes by the SEC will be posted to the ISB's website at www.cpaindependence.org when confirmation is received by the Board.

Definitions

6. Terms and phrases noted in **bold** in the Standard are defined below:

a. **Investment adviser.** Manages the mutual fund's portfolio according to the objectives and policies described in the fund's prospectus, executes its portfolio transactions, and typically serves as distributor of its shares to investors. When a **"sub-adviser"** substantively acts in the overall management role of an investment adviser with respect to a fund, it is to be considered the same as an investment adviser. (A **sub-adviser** is an entity generally identified, subcontracted and overseen by the investment adviser for a portfolio management role.)

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[1] If the related non-fund entity is an **investment adviser**, this would include all funds it advises, even if they are outside this mutual fund complex.

[2] If the fund's investment adviser is outside the mutual fund complex, the independence requirement still applies. That independence restriction further extends to any parent company to which the investment advisory fees from the client funds are material, and to all other subsidiaries of those covered parent companies.

b. **Mutual funds.** Investment companies subject to the Investment Company Act of 1940. These include, for example, open-end and closed-end funds, and unit investment trusts.

c. **Mutual fund complex.** The mutual fund operation in its entirety, including all the funds, plus the sponsor, its ultimate parent company, and their subsidiaries.

d. **Non-fund entity.** For example, the investment adviser, a broker-dealer, a bank, or an insurance company in the mutual fund complex.

e. **Sister funds.** Mutual funds in a complex with a common investment adviser.

f. **Those in a position to influence the audit.** Those in a position to influence the audit are those who supervise or have direct management responsibility for, (including at all successively senior levels, up through the firm's chief executive), or provide technical consultation, quality control or other oversight of, the partners and staff members involved in the audit. (In determining whether an individual meets one of these criteria, firms must be sensitive to their immediate practice environment. For example, in a small office, practice unit or firm, all partners might be considered as in a position to influence the audit, even if in an informal manner.)

BACKGROUND

7. At its March 12, 1999 meeting, the Board agreed that certain mutual fund issues should be added to its project agenda, and that the project should be expedited by moving directly to an Exposure Draft (ED). The project had been recommended in a letter from the Chief Accountant of the SEC and also requested through practice experience. A Board oversight task force was appointed to provide guidance for the project, and a broad-based project task force reviewed the documents for completeness and clarity.

8. In September 1999 the ISB issued ED 99-1, *Certain Independence Implications of Audits of Mutual Funds and Related Entities*. The ED proposed rules similar to those in this final Standard, except that it also would have required independence of partners (and, in certain cases, those defined as "managerial employees") in an office participating in a significant portion of the audit engagement.

9. The Board received twelve letters in response to the ED, all of which were generally supportive, and many had specific suggestions for changes. After deliberation, the Board agreed with certain of those recommendations, as described in the "Basis for Conclusions."

10. In June 2000 the Board determined to modify the effective date of this Standard as described in paragraph 5. An exposure draft proposing this change was issued and seventeen comment letters were received, virtually all of which supported this amendment.

11. The Board's general rules (the published SEC rules adopted at the commencement of the Board) require an audit firm, and its "members" (as defined), to be independent of its audit clients. This general independence requirement is not changed by ISB Standard No. 2, except as to paragraph 4.

BASIS FOR CONCLUSIONS

Introduction

12. The Board's desire is to provide guidance in mutual fund auditor independence issues to help ensure, in a rapidly changing environment, the continued integrity of audited financial statements for the ultimate benefit of investors and other users of these statements.

13. It is believed the Standard will also significantly reduce a perceived lack of clarity in present guidance, and thereby reduce likely diversity in practice.

14. To accomplish its goal, the ISB weighed a variety of significant factors, some of which are described below, in reaching its determination of an appropriate Standard.

Attributes of the Mutual Fund Organizational Structure

15. The organizational structure of a mutual funds complex (See Appendices A and B) varies significantly from that of a typical corporation, and the Board believes these differences are relevant to the setting of auditor independence standards. Specifically, SEC Regulation S-X, Rule 2-01 (b) states that auditor independence is required as to the client and "... any of its parents, its subsidiaries, or other affiliates...," but the typical mutual fund/adviser relationship is not that of a subsidiary/parent. Among the principal differences are that:

a. In an investment adviser/mutual fund relationship, there is no majority ownership or voting control, as is present in a parent of a subsidiary; and

b. Unlike the case of a subsidiary, the investment income of a mutual fund, after the deduction of adviser management fees, distribution fees, and other fund expenses, is distributed to the fund shareholders as opposed to the related investment adviser.

On the other hand, while not having voting control of a fund, the investment adviser usually provides the fund's officers and performs substantially all services required in its operations, and thus plays an important, even controlling, role in its policies and operations.

Analysis of Common Service Providers

16. Mutual funds often use common service providers to centralize services and control costs, and the Board believes such common services are relevant to the related independence issues. In analyzing the key factors and threats relevant to the sister fund issue, the Board concluded that the use among funds of a common investment adviser was an important enough link to provide the basis for the independence restriction. In response to comments received on the ED, the circumstances under which "sub-advisers" also would be restricted were clarified to cover only those situations in which the sub-adviser substantively acts in the overall management role of an investment adviser, because it is in that role, rather than as a portfolio manager, that any potential threat to independence exists.

17. The Board also considered the providers of other common services, including fund boards of directors and accounting systems, but concluded they were less relevant than a common investment adviser and that the

independence restriction should be based solely on the presence of common investment advisers.

Difference between Defined Benefit and Defined Contribution Plan Investments

18. The Board distinguished between the firm-directed investments of firm defined benefit plans and the self-directed investment choices available in certain firm defined contribution plans (such as 401(k) plans), and concluded that the risks differed sufficiently to provide a lesser restriction for certain personnel in the defined contribution plans. That is, the direct beneficiary of investment performance in a defined benefit plan is the firm sponsor, since the level of further firm contributions will be affected by the investment performance. By contrast, the direct beneficiary of investment performance in a defined contribution plan is the employee. As a result, the Board concluded that the firm's defined benefit plans should not be able to invest in non-audit client sister funds, but that the firm could offer a sister fund investment alternative in its defined contribution plans to non-involved partners and staff without impairing its independence.

Partner Spousal Employee Benefit Plan Investments

19. The Board recognizes that permitting investments through employer-sponsored benefit plans by partners' spouses in mutual funds that are audit clients is not consistent with the present rules. However, the Board also believes this change to be warranted as a practical good in this changing social environment, because the risk that such investments will adversely affect audit quality appears trivial. A number of factors were considered in reaching this conclusion, including the following:

a. Many more spouses are working today;

b. Benefit plans (especially 401(k)s) have become much more common;

c. Audits of mutual funds in those plans have become more concentrated within a few large firms due to consolidation of both financial institutions and auditors;

d. A number of plans provide only one family of mutual fund investments. Under existing rules, if the funds are audit clients of a firm, the spouses and dependents of all partners in the firm would be prohibited from participating in the plans. As a result, the person would lose tax deferral benefits and employer matching contributions, and sometimes have to forfeit accumulated benefits; and

e. It is highly unlikely that those who are exempted could influence the audit.

This decision will be reconsidered when the Board addresses the question of investment in audit clients comprehensively.

Firm Significant Influence Over an Entity in the Mutual Fund Complex

20. Paragraph 2 restricts a firm when its partners collectively have significant influence over an entity in the mutual fund complex. The intent in making such a determination is to address situations where partners are "acting together" in this investment. On the other hand, later knowledge that numerous

partners, not having knowledge of one another's common investments, could have had "significant influence" over the entity if they acted together would not indicate that "significant influence" had existed at the earlier date.

Those in a Position to Influence the Audit

21. Paragraph 3 restricts firm partners and employees who are on the audit engagement team and those in a position to influence the audit. (The phrase "those in a position to influence the audit" was substituted for "chain of command," in response to comments received on the ED because it is more descriptive of the individuals included.) The definition of the phrase "those in a position to influence the audit" in paragraph 6*f* describes two groups of individuals who may have such influence: those with direct management responsibility, and those who provide technical or related consultation. It is intended that the individuals with direct management responsibility for the audit and for related accounting, auditing and similar consultation services be subject to the restrictions of this Standard, whether or not they participate in any way in the audit. On the other hand, professionals in a consulting department, other than the person in charge, may be "recused" and therefore made not subject to the Standard's restrictions, if they in fact are not, and will not be, involved in any way in the audit.

Uninvolved Partners and Managerial Employees

22. Several respondents to the ED suggested that it was unnecessary to include all partners and managerial employees working in the office conducting the audit in the category of those in a position to influence the audit. After deliberation, the Board agreed that there was at most a remote threat to independence from such individuals, if they were otherwise uninvolved in the audit. Consequently, the final Standard does not restrict those persons from investing in sister mutual funds, or their immediate family members from investing in client mutual funds through an employer defined contribution plan. Existing independence rules, however, prohibit their direct investment in client funds.

Analysis of Other Bases for Evaluating Independence Restrictions

23. In addition to considering the commonality of service providers for sister funds as described above, the Board also considered other and broader alternative bases for evaluating auditor independence in the mutual fund environment. For example, various applications of materiality tests were considered, as was the application of independence restrictions on a case-by-case basis to counter specific threats. The Board concluded that its Standard better fulfills its needs, in part because it provides a simpler but effective approach to addressing the independence threats raised.

Risks/Threats and Safeguards Analysis

24. In view of the importance of a risks/threats analysis and the need for related safeguards, the Board considered extensively the potential for particular independence concerns. This included those threats possible if an auditor were to encounter a systemic problem during the course of auditing one fund that would adversely impact another non-client fund in the complex, shares of which are owned by other individuals in the auditor's firm. (A safeguard to

mitigate this potential threat is the fact that the non-client fund would be audited by a different firm.) The general concerns—the possible loss of objectivity in the audit and the need for independence in both fact and appearance—also were discussed. The Board's determination was that while some threats could be envisioned specific to mutual fund-related situations, any remaining threats to the auditor's independence, after considering existing controls and the application of this Standard, were insignificant.

Deferral of Effective Date

25. ISB Standard No. 2 is an integrated set of provisions which the Board believes is appropriately restrictive to protect the public interest and be responsive to the threats envisioned, while not imposing restrictions on those other individuals where the Board believed the risks to be minimal. The Standard developed under this new approach included provisions both more and less restrictive than current SEC rules, principally because of its "on the engagement" focus and spousal benefit plan exemption.

26. The Board initially decided, when ISB No. 2 was issued in December, 1999, that the more restrictive provisions of the document should go into effect on the then-scheduled effective date of June 15, 2000, regardless of whether or not the SEC had amended its more restrictive rules by that time. The "effective date" language in the original Standard read as follows:

> The above requirements are effective with respect to audits of financial statements for periods beginning after June 15, 2000, with earlier application encouraged. However, in certain respects, current rules of the SEC and, as to spousal employee benefit plan interests, of the AICPA, are more restrictive than the provisions of this Standard. Compliance with those existing more restrictive rules continues to be necessary unless and until both the SEC and the AICPA revise those rules. Notification that these changes have been made will be posted to the ISB's website at www.cpaindependence.org when confirmation is received by the Board. Where provisions of this Standard are more restrictive, those provisions are to be complied with as of the above effective date.

27. Subsequently, questions were raised as to the appropriateness of a partially effective Independence Standard, on the basis that it would add unnecessarily to the existing complexity of regulations.

28. Based upon its consideration of various factors, the Board determined that a deferral of the original June 15, 2000 effective date of ISB Standard No. 2 until 60 days after existing rules of the SEC are modified to remove conflicts with the Standard is in the best interests of its constituents and therefore appropriate.

29. In reaching this decision, the Board acknowledges the statutory oversight responsibility of the SEC for the activities of the Board. In light of that, it concluded that it would not be desirable to impose a set of new independence restrictions while existing rules remain in effect until the SEC endorsed (or indicated it did not object to) such new rules by modifying its existing ones.

30. In May 2000 the AICPA's Professional Ethics Executive Committee adopted the following policy statement:

> As to any pronouncement passed by the Independence Standards Board (ISB), the Professional Ethics Executive Committee (PEEC) will treat such a pronouncement as authoritative for any engagement requiring independence unless and until the PEEC announces that it will not view that pronouncement as authoritative. Accordingly, in situations where an AICPA standard is more

> restrictive, in total or in part, than an ISB pronouncement, the PEEC will not consider a member's independence to be impaired as a result of their noncompliance with respect to a more restrictive AICPA standard until members are given notice of the PEEC's rejection of the ISB's less restrictive pronouncement.

Consequently, the language regarding the AICPA's rules has been deleted from the effective date paragraph.

Summary

31. Based upon:

a. Its consideration of the unique organizational structure of mutual fund entities;

b. The differences inherent in self-directed defined contribution employee benefit plans;

c. The lack of apparent significant independence risk from mutual fund audits; and

d. The very limited threats to auditor independence from participation in an employer-sponsored benefit plan by spouses and dependents of those neither on the audit engagement team nor in a position to influence the audit,

the Board believes its Standard is appropriately restrictive to protect the public interest and be responsive to those threats that were envisioned, while not imposing restrictions on those other individuals and plans where the Board believes the risks are minimal.

32. The Board recognizes that every additional requirement imposes costs, but the Board believes that the costs to implement this pronouncement will be small when compared with the benefits.

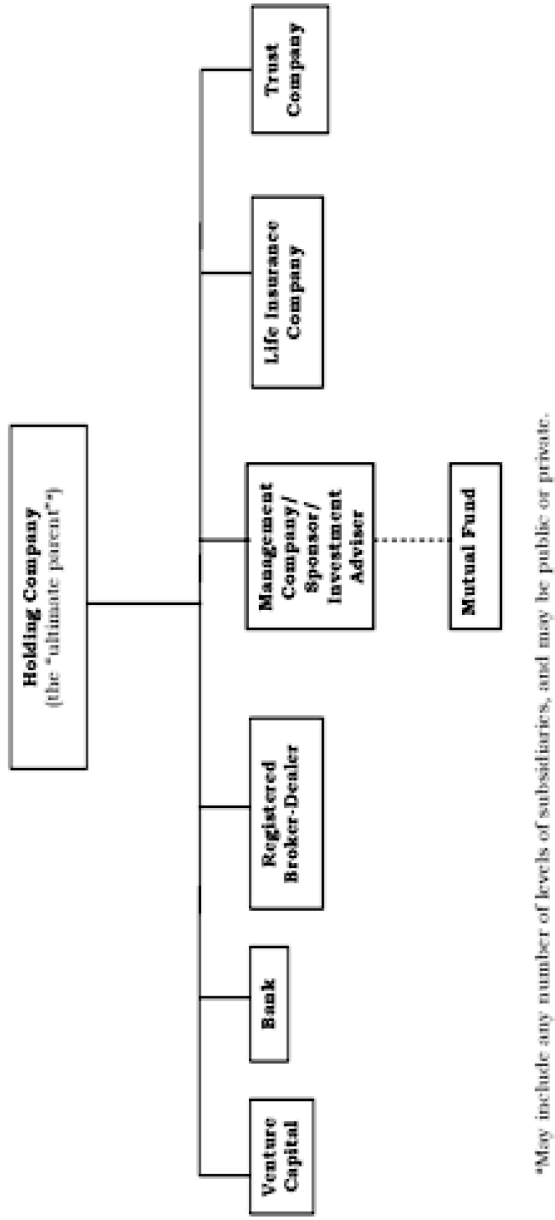
33. This Standard and its amendment were both adopted unanimously by the Board.

Members of the Independence Standards Board

William T. Allen, *Chair*	Manuel H. Johnson
John C. Bogle	Philip A. Laskawy
Stephen G. Butler	Barry C. Melancon
Robert E. Denham	James J. Schiro

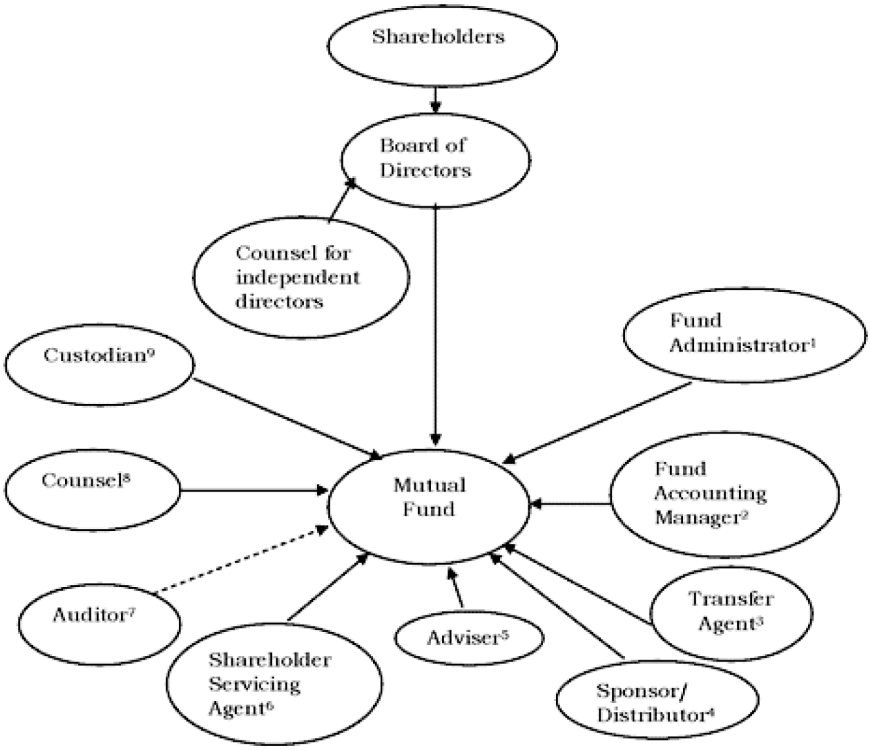
Appendix A

Organization Chart
The Structure of a Typical Mutual Fund *Complex*



Appendix B

Organization Chart
The Structure of a Typical Mutual *Fund*



1. Makes presentations for the board, and prepares SEC, tax and shareholder reports.
2. Maintains *fund's* accounting records, computes net asset value (NAV) daily and forwards NAV to transfer agent, and prepares the fund's financial statements.
3. Maintains *shareholder* accounting records and issues share certificates.
4. Conceives the fund and markets it to investors.
5. Manages the fund and executes its portfolio transactions. Also provides portfolio management services and overall executive management of the fund, including (in consultation with the board) selection of other service providers.
6. Responds to shareholders' inquiries by accessing records maintained by Transfer Agent.
7. Audits the fund's financial statements.
8. Provides legal services.
9. Holds securities in safekeeping; receives and delivers securities as instructed. Except for the auditor, the only entity servicing the fund which (absent meeting certain incremental criteria) *must* be independent of the fund complex.

Independence Standards Board Standard No. 3
Employment with Audit Clients

Important Note: The Securities and Exchange Commission recently released a comprehensive revision to its auditor independence requirements (the Revision). The Revision contains provisions covering settlement of capital and retirement interests when former firm professionals join firm audit clients, which supercede the requirements described in paragraph 2*b*iv of this standard. Consequently, at the next ISB meeting, the ISB staff will recommend that the Board delete paragraph 2*b*iv of this standard. All other provisions of this standard remain in effect. The Revision can be found at the SEC's website at www.sec.gov.

July 2000

SUMMARY

This standard describes safeguards that firms should implement when their professionals join firm audit clients. These safeguards are designed to assist in ensuring that:

- professionals who are broadly evaluating their career options will exercise an appropriate level of skepticism while performing audits prior to their departure from the firm;
- a former firm professional now employed by the client cannot circumvent the audit because of familiarity with its design, approach, or testing strategy; and
- the remaining members of the audit team maintain objectivity when evaluating the work and representations of a former firm professional now employed by the audit client.

The procedures should be adapted depending on several factors, including whether the professional served as a member of the audit team, the positions he or she held at the firm and has accepted at the client, the length of time that has elapsed since the professional left the firm, and the circumstances of his or her departure.

The standard also specifies the circumstances under which capital and retirement balances owed to the departing professional should be liquidated or settled to preserve the firm's independence.

The standard's requirements are effective for employment with audit client situations arising after December 31, 2000.

STANDARD

Underlying Principle

1. An audit firm's independence is impaired with respect to an audit client that employs a former firm professional who could, by reason of his or her knowledge of and relationships with the audit firm, adversely influence the quality or effectiveness of the audit, unless the firm has taken steps that effectively eliminate such risk.

Safeguards

2. An established program of safeguards including the following procedures, when conscientiously administered, is deemed to constitute steps that effectively eliminate the risk of independence impairment:

a. Pre-change in employment safeguards:

i. Firm professionals are required promptly to report to the firm conversations between themselves and an audit client respecting possible employment.

ii. Firm professionals engaged in negotiations respecting possible employment with an audit client are immediately removed from the audit engagement.

iii. Upon removal of a professional from the audit engagement as provided above, the firm reviews the professional's work to assess whether he or she exercised appropriate skepticism while working on the audit engagement.

b. Post-change in employment safeguards:

i. If a professional accepts employment with the audit client, the on-going engagement team gives active consideration to the appropriateness or necessity of modifying the audit plan to adjust for risk of circumvention.

ii. When a former firm professional joins an audit client and will have significant interaction with the audit team, the firm takes appropriate steps to provide that the existing audit team members have the stature and objectivity to effectively deal with the former firm professional and his or her work.

iii. When a former firm professional joins an audit client within one year of disassociating from the firm and the professional has significant interaction with the audit team, the next following annual audit is separately reviewed by a firm professional uninvolved in the audit to determine whether the remaining engagement team maintained the appropriate skepticism when evaluating the representations and work of a former firm professional. The extent of this review should be tailored based on the position that the former professional has assumed at the audit client and other facts and circumstances that would heighten or mitigate threats to independence.

iv. The firm requires the prompt (1) liquidation of all capital balances of former firm partners who become employed by an audit client; (2) settlement[1] of all retirement balances[2] of former firm professionals who become so employed that are not both immaterial to the firm and fixed as to amount and timing of payment; and (3) settlement of retirement balances of any firm professional, regardless of the financial immateriality of such balances to the firm, when, within five years of disassociating from the firm the identity of such former firm professional as an officer or employee of the audit client is required to be disclosed in the audit client's proxy statement or annual report filed with the Securities and Exchange Commission (SEC) pursuant to its regulations.

Effective Date

3. The above requirements are effective for employment with audit client situations arising after December 31, 2000.

BACKGROUND

4. The Board began to study the independence implications of audit firm professionals going to work for the firm's audit clients shortly after its formation. After determining that guidance was needed in these situations, the Board began the process of developing a standard concurrent with its work on a conceptual framework for auditor independence.

5. A Discussion Memorandum (DM 99-1, *Employment with Audit Clients*) covering the issues was prepared with the assistance of a Board oversight task force, and a broad-based project task force consisting of representatives from the investor, preparer, academic, and regulator communities, in addition to members of the auditing profession. The DM was released in March 1999 for a 90-day comment period. Comment from investors was specifically sought; the DM was mailed to several investor organizations and to 370 institutional investors in an effort to encourage responses from that constituency. Twenty-eight comment letters were received. After considering these letters, and with further assistance from the project and Board oversight task forces, the Board developed a proposed standard for public comment.

6. An Exposure Draft (ED) of the proposed standard was released at the end of December 1999 with a comment period that ended on February 29, 2000.

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[1] In the United States, the payment of retirement benefits to the individual would immediately subject such benefits to income taxes. In some cases, this tax liability can be deferred by transferring the remaining retirement benefits to an Individual Retirement Account or similar vehicle, in which case the amounts become taxable only when paid to the individual. In other cases, the amount can be transferred to a "Rabbi Trust" which also serves to defer such income taxes. A Rabbi Trust is an irrevocable trust whose assets are not accessible to the firm until all benefit obligations have been met; however, such assets are subject to the claims of creditors in the event of the firm's bankruptcy or insolvency. To meet the requirements of this standard, such a trust can only be used if the amounts are fixed as to amount and timing of payment (i.e., the benefits do not fluctuate based on firm results, and the present value of benefits due to the departing professional can be calculated and placed in the trust), and the bankruptcy of the firm is considered remote.

[2] Retirement balances as used in this statement do not include a professional's benefits under the firm's defined contribution plan, such as a 401(k) plan, if the firm has no obligation to fund the individual's benefits after he or she disassociates from the firm.

Copies of the ED were mailed to a variety of individuals and groups, including those representing investors, to encourage and solicit responses. Fourteen comment letters were received. After considering these comments, and with further assistance from the project and Board oversight task forces, the Board approved the issuance of this standard.

THREATS TO INDEPENDENCE

7. The concerns expressed when professionals leave firms to join audit clients are generally threefold:

a. That partners or other audit team members who resign to accept positions with audit clients may not have exercised an appropriate level of skepticism during the audit process prior to their departure.

b. That the departing partner or other professional may be familiar enough with the audit approach and testing strategy so as to be able to circumvent them once he or she begins employment with the client.

c. That remaining members of the audit team, who may have been friendly with, or respectful of a former partner or other professional when he or she was with the firm, would be reluctant to challenge the decisions of the former partner or professional and, as a result, might accept the client's proposed accounting without exercising appropriate skepticism or maintaining objectivity.

8. The perceived threats to auditor independence when the former partner or professional has retirement benefits or a capital account with the audit firm are as follows:

a. It may appear that ties between the audit firm and the partner or other professional have not been severed—that the firm has placed its "own man" (or woman) at the client, functioning as management, and is in effect auditing the results of its own work.

b. If the retirement benefits of the former partner or other professional vary based on the firm's profits, then the former partner or other professional may be inclined to pay the firm higher fees to inflate his or her retirement benefits (or to increase the likelihood of receiving benefits in unfunded plans). As a result, the firm may be less rigorous in its scrutiny of the client's accounting policies because its fees are overly rich.

c. If the former partner's or other professional's unfunded retirement benefits or other monies held by the firm are material to the firm and the firm is experiencing cash flow problems, the firm may be less rigorous in its audit of the client's financial statements in exchange for forbearance on the amounts owed to the former partner or other professional.

BASIS FOR CONCLUSIONS

9. The Board's desire is to protect the quality and integrity of audited financial statements for the ultimate benefit of investors and other users of those statements. To accomplish this goal, the Board weighed a variety of factors, some of which are described below, in determining an appropriate approach to address the threats to auditor independence posed by situations where firm professionals join audit clients.

Effectiveness of Safeguards

10. The Board believes that the safeguards described in this standard will effectively protect auditor independence in situations where firm professionals go to work for their audit clients. A requirement to review an individual's work after he or she enters into employment negotiations with an audit client and, when appropriate, review the engagement team's work on the subsequent audit, is expected to have a deterrent effect. First, the expectation is that professionals who are broadly evaluating their career options will be more careful to ensure that the work they perform, including the decisions they make during the audit, will withstand scrutiny when they know it will be subject to a special review if they enter into employment negotiations with the audit client. Second, the skepticism of the remaining audit team members when evaluating the statements of a former colleague or leader may be higher; knowing that their work will be reviewed, individuals will most likely be more sensitive to appearing to have acquiesced to a client's aggressive or incorrect accounting, and will be more likely to refrain from doing so.

11. Open discussion of the client's employment of audit firm professionals with the audit committee or board of directors, as required in certain circumstances by ISB Standard No. 1, *Independence Discussions with Audit Committees*, can also serve as an effective safeguard. Airing, "in the sunshine," the potential threats to independence posed by these situations, and the safeguards employed by the firm to protect auditor independence, is likely to sensitize those involved (both the former firm professional now with the client and the remaining audit team) to these issues, and make independence impairments less likely. In addition, while auditors are responsible for upholding their own professional standards, including those related to independence, the audit committee can "set the tone at the top," and emphasize the proper separation between management and the auditor.

12. In developing the standard, the Board allowed for flexibility in adapting the safeguards to the facts and circumstances of the employment situation. The Board believes, for example, that the concerns one would have when a partner joins a client would exist, but to a lesser extent, when professionals with lower levels of responsibility join clients. These concerns would also vary depending on the nature and level of responsibilities assumed by the professional in his or her new role at the client. In addition, the issues may vary for active versus retired partners and other professionals, those leaving the firm voluntarily versus those terminated, and *engagement* professionals versus firm professionals having little or no direct prior professional relationship with the client. Therefore, the Board believes that an effective standard must establish principles that contemplate a variety of situations, especially as the structure of firms change, and more professionals are given new responsible, non-partner roles in firms.

13. The safeguards proposed in the ED contemplated a review of the former firm professional's work upon employment by the audit client. After further consideration, the Board determined that the trigger for this review should be instead the commencement of employment negotiations between the firm professional and the audit client. The Board believes that the concerns about the work of an audit team member contemplating employment with his or her audit client would exist regardless of whether the firm professional eventually accepted a position at the client. Audit team members in employment negotiations with an audit client should be returned to the engagement only if negotiations cease and employment is no longer sought.

14. When a former firm professional joins an audit client within one year of disassociating from the firm and the professional has significant interaction with the audit team, the standard requires an additional review of the next annual audit following the professional's acceptance of employment. This review is meant to determine whether the audit team had an appropriate level of skepticism when evaluating the work and representations of the former firm professional. Some asked whether such a review should always be performed prior to the firm's "sign-off" on the audit. The Board concluded that the primary benefit of the review is its deterrent effect. That is, members of the audit team, knowing that their work will be subject to an additional review, will be less likely to acquiesce to questionable client proposals. Further, mandating such a review prior to issuance of the audit report could result in deferring for a significant period of time release of the audited financial statements. Such a delay could impose a significant cost to users of financial statements and the Board did not consider the additional benefits, if any, of a pre-issuance review to justify such costs.

Peer Review

15. The ED proposed a requirement that firms have their compliance with the provisions of the standard evaluated in a peer review. The Board believes that peer review of firms' compliance with all auditing and quality control standards, including independence standards, is an important component of the profession's self-regulation. The Board ultimately concluded, however, that the scope or content of established peer review programs should be left to those that administer them, and that mandating participation in such a program should be left to other groups in the profession's regulatory system.

Settlement of Financial Interests

16. The Board considered the necessity of a "full-payout" requirement in situations where capital account and retirement obligations are immaterial to the firm, and fixed as to amount and timing of payment. The Board believes that a former partner of an audit firm who is employed by the firm's audit client should not remain an equity investee in the firm. Accordingly, the standard requires the firm to liquidate all capital accounts prior to the employment of the professional by the audit client, regardless of their materiality.

17. With respect to retirement obligations, the standard requires the firm to settle such obligations prior to employment by the client in all situations where a professional's benefits are not immaterial to the firm, and fixed as to amount and timing of payment. The Board concluded, however, that retirement obligations owed to a former professional that *are* both fixed and immaterial to the firm are not likely to impinge on the firm's independence. On the other hand, it recognized that unsettled amounts may present an "appearance" concern when a former firm professional joins an audit client in a visible position where his or her former employment at the client's audit firm is likely to be disclosed or known. Therefore, the standard mandates settlement of even immaterial retirement obligations when a former firm professional joins an audit client within five years of disassociating from the firm in a position where his or her name is required to be disclosed in the company's proxy statement or annual report to the SEC. However, because the character of retirement benefits is different from capital balances, the Board concluded that settlement of retirement obligations could be done through a "Rabbi Trust" or similar vehicle in certain circumstances.

18. In reaching its conclusions regarding retirement balances, the Board was concerned that a requirement to settle all obligations could create significant tax or other liabilities for the departing partner in either the United States or in a foreign country. In addition, such a requirement might jeopardize the tax status of certain qualified plans if all plan participants were not treated equally. Such a result could serve to either actively discourage the partner from accepting the employment position, require the client to engage a new audit firm, or drive firms to reduce benefits provided under its plans because of accelerated funding requirements. The Board did not believe such consequences were in the public interest except for benefits that were not both fixed and immaterial to the firm, and in the limited circumstances involving former partners identified in an SEC filing, as described in paragraph 2*b*iv.

19. Some expressed concern that a former firm professional could join a large, multinational audit client several years after leaving the firm, perhaps at a foreign location. In these circumstances, it is possible that the firm would not be aware of the former professional's new position at the audit client, and may not have liquidated capital balances, or retirement benefits that are not both immaterial and fixed. The Board does not intend that an inadvertent and isolated failure to comply with these settlement provisions be deemed an impairment of independence. It does expect, however, that firms will impose conditions on former professionals who have remaining capital accounts or other than immaterial and fixed retirement benefits with the firm. One of those conditions should be to advise the firm when they are contemplating a change in employment, to allow the firm to determine if the new employer is a client subject to this standard. These arrangements should eliminate the need to implement elaborate and burdensome partner and employee tracking systems to comply with the provisions of the standard—a concern of some of the respondents to the ED. However, any inadvertent failures to comply should be corrected as soon as identified.

20. In reaching these conclusions, the Board considered making several distinctions, suggested by respondents to the DM, in determining when standards should require a full-payout of retirement benefits. These respondents suggested that a settlement requirement distinguish between defined contribution plan benefits and defined benefit plan benefits, fully funded benefits versus unfunded amounts, fixed benefits versus those that vary based on profits, and other criteria. The Board concluded that benefits which are other than immaterial to the firm, or that vary based on, for example, firm profitability, should always be settled, regardless of the amount of time that has elapsed since the professional's departure from the firm. In addition, the Board concluded that the settlement requirement should not extend to defined contribution plan benefits such as those in a 401(k) plan if the firm has no ongoing obligation to fund the individual's benefits.

The Board's Consideration of a Mandated Cooling-Off Period

21. In studying these issues, the Board considered and rejected a mandated "cooling-off period"—a rule deeming an impairment of the firm's independence when certain firm professionals join an audit client. The Board concluded the costs of such a rule would exceed its benefits.

22. A cooling-off approach would mean either deeming independence to be impaired if *any* firm professional accepted an employment offer from an audit client, or specifying which types of persons would be included in such a rule and which would not. The former course seemed unnecessary, and the latter very complex or arbitrary, since the types of individuals who might represent

threats would presumably depend upon their positions in the firm, their roles in the audit, and the positions they would be assuming at the audit client. Generalizing when that combination might constitute a threat to auditor independence and when it would not seemed to be a daunting task which should not be undertaken when an effective alternative is available.

23. The Board believes that with the appropriate safeguards in place, as called for by this standard, the threats to auditor independence are slight. In addition, the Board believes that the benefits to society and the profession of allowing firm professionals to accept employment with audit clients, without fear of jeopardizing their former firm's independence, outweigh the costs. In reaching this conclusion, the Board recognizes that a mandatory cooling-off period may promote the appearance of independence more completely, and might *eliminate* the risk that the audit team could be unduly influenced by a former colleague, but it believes the differences in actual threats to independence under the two approaches are insignificant.

24. The Board recognizes that the attraction of future employment opportunities draws talented and ambitious recruits to the profession. Turnover at public accounting firms can be quite high, and many recruits do not intend to stay long enough to be promoted to partner. Furthermore, they join public accounting firms because of the broad experience they expect to gain at the firm, and the contacts they expect to make in industry. In addition, turnover within the partner ranks has increased in the last few years. If the future employment prospects of recruits and experienced auditors now working for audit firms were limited by a mandated cooling-off period, the Board is concerned that the caliber of professional attracted to public accounting might decline.

25. The Board agreed with several corporate officials and others responding to the DM who argued that companies benefit from the ability to hire staff at all levels from their audit team. An auditor who has worked for several years on an engagement is often thoroughly familiar with the client's systems, and knows most of the client's key people and their responsibilities. Beyond familiarity with the hiring company, the auditor brings broad experience "to the table" from working at a variety of companies, and sometimes in a variety of industries. In addition, partners and professionals in public accounting firms are generally recognized as experts in accounting, financial reporting, and internal control matters—skills needed by companies with financial reporting responsibilities to investors.

26. A mandated cooling-off period might force a client to choose between, for example, its audit partner and its audit firm, knowing that if the partner was hired, the audit firm would have to be replaced. The Board recognizes that replacement of an audit firm carries costs to firms, clients, and investors. There is a learning curve on a first-year audit; auditors spend significantly more time and resources on them (developing audit programs, familiarizing themselves with the system of internal controls, etc.), and client personnel spend more time answering the auditors' questions and producing documentation previously provided to the prior auditors. And because the Board believes that audits are strengthened by institutional continuity, rotation of auditors and the increased risk that the first-year audit poses carries a cost to investors.

27. The Board acknowledges the counter-argument that a fresh look by a new audit team may carry some benefits that cannot be achieved with the same audit team and approach year after year. The consideration of a requirement that companies change audit firms periodically, however, is beyond the scope of this project.

28. The Board also concluded that a restriction on hiring former audit partners or other professionals may be a heavier burden to smaller corporations in need of the accounting expertise provided by someone familiar with their business and industry, and to smaller firms. Smaller corporations may be at a disadvantage in recruiting personnel when competing with larger companies with strong national or regional name recognition. Restricting these smaller companies from hiring directly from their audit firm (from among those who know the company well) may hurt them disproportionately.

29. Professionals from smaller accounting firms may face the same difficulties when competing in the job market with professionals from large, well-known firms. A rule that impairs the ability to go from an audit firm directly to a client, where management knows you and you have had a chance to demonstrate your abilities, may be more of a burden if you work for a smaller firm.

30. Finally, the Board concluded that a mandatory cooling-off period would be ineffective in preventing fraud or collusion between the auditor and client. If the firm professional and client management were intent on committing fraud, the professional might remain with the firm rather than risk turning the engagement over to another individual who may uncover the conspiracy. In addition, if management wanted to compensate a firm professional for his or her role in a fraud, a ban on hiring the professional for a certain period of time would not prevent the company from providing payments to the professional, after he or she resigns from the firm, via consulting contracts or other means.

Other Matters

31. The Board concluded that the threats to auditor independence described in this standard are in many respects different from those that arise when former firm professionals are elected as non-executive members of the Board of Directors. Existing rules cover these non-executive director situations and remain in effect.

32. This standard was adopted unanimously by the Board.

Members of the Independence Standards Board

William T. Allen, *Chair*	Manuel H. Johnson
John C. Bogle	Philip A. Laskawy
Stephen G. Butler	Barry C. Melancon
Robert E. Denham	James J. Schiro

ISB Interpretation 99-1

Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)

The Independence Standards Board (ISB) is examining the broader issue of an auditor's association with valuations and fairness opinions. This interpretation, which is based on existing guidance, will not be considered precedent when the ISB addresses the broader issue and may be subject to change based on the ISB's conclusions reached after the public comment process.

Date Discussed: March 12, 1999

Date Issued: March 12, 1999

Issue

1. In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 133, "Accounting for Derivative Instruments and Hedging Activities" (FAS 133). FAS 133 requires that all derivatives be recorded on the balance sheet at fair value. Changes in fair value flow through the income statement, unless the instrument qualifies as a hedge, as defined. The statement is effective for fiscal years beginning after June 15, 1999, but companies can adopt the statement as of the beginning of any fiscal quarter that begins after June 1998.

2. For many companies, the complexity of the statement and of the underlying financial instruments will make the implementation process difficult. Company management may need help in understanding the statement's requirements; derivatives must be identified, inventoried, and measured at fair value; hedging relationships must be designated anew and documented as of the implementation date; and many companies will need system modifications in advance of implementation to develop and track the various required fair value measurements.

3. As a consequence of the complexity and implementation challenges inherent in adopting FAS 133, audit firms are likely to find themselves responding to many types of client requests for assistance. This interpretation provides guidance on the auditor independence implications of likely areas of requested assistance, solely with respect to the implementation of FAS 133.

Independence Concerns

4. As it considered these issues, the Board discussed the potential threats to auditor independence. Appraisals and valuation services potentially threaten the auditor's independence because of a "self-review" concern. Under the existing rules, the auditor cannot be placed in the position of "auditing his or her

own work" (or the work of someone else in his or her firm). In addition, acting in a capacity equivalent to that of management is viewed as a threat to auditor independence. The auditor may lose his or her objectivity if he or she makes decisions for or develops a mutuality of interest with the client by, for example, valuing the client's assets.

ISB Discussion and Interpretation

5. The Board considered two broad areas of likely assistance and how the existing independence rules would be applied. One category of services relates to the accounting application and the second involves valuation consulting services.

6. Management is responsible for the financial statements, and responsibility for the choices and judgments inherent in the preparation of those financial statements cannot be delegated to the auditor or to anyone else. Whatever the service being provided, the auditor must understand the level of management's expertise and must be satisfied that management has taken responsibility for the assumptions and judgments made during the course of the work, and for the results produced.

7. The Board has concluded that the auditor may provide consulting services on the proper application of FAS 133, including assisting a client in gaining a general understanding of the methods, models, assumptions, and inputs used in computing a derivative's value. To ensure, however, that the auditor's independence is not threatened, as discussed in paragraph 4, the auditor may not prepare accounting entries, compute derivative values or be responsible for key assumptions or inputs used by the client in computing derivative values.

8. The auditor's independence would be impaired if he or she created the initial journal entries that are used to implement or apply the standard, or if in providing the services described below, the auditor's level of assistance was tantamount to doing the work himself or herself.

9. Based on these general guidelines, the following is a list of illustrative services that the auditor may be asked to provide an audit client in implementing FAS 133, along with the Board's conclusions on which of these would impair the auditor's independence.

Accounting Application Assistance

10. Accountants are likely to work with clients in implementing the accounting requirements of FAS 133. Providing guidance to clients (which for this purpose encompasses discussing the requirements of FAS 133, providing advice, and expressing views as to how FAS 133 would be applied in the client's situation) would not impair independence. Performing services which would be subject to audit procedures such as compiling the inventory of derivatives, creating the initial journal entries to be recorded, initially determining whether specific derivatives meet the relevant criteria as hedges, or making management decisions concerning the implementation of FAS 133 would impair the auditor's independence.

11. The provision of the following services would not impair the auditor's independence:

a. Discuss the requirements of FAS 133 and the related concepts, terminology and implementation issues.

b. Provide sample journal entries used to apply FAS 133.

c. Provide guidance in compiling an inventory of derivatives, as defined by the new rules.

d. Provide guidance in determining whether specific derivatives meet the relevant criteria as hedges, or provide examples and discuss factors to be considered in formally documenting any hedging relationships and the entity's risk management objective and strategy for undertaking the hedge.

e. Discuss factors to be considered in making judgments that may become critical in the accounting process, including the separation of the intrinsic value of instruments from their "time value." This separation of an instrument's fair value into its component parts might have accounting consequences within the financial statements (FAS 133 permits the exclusion of the inherently ineffective portion of a derivative's change in value, such as the time value of options, from the "hedge effectiveness" assessment).

f. Provide guidance in determining the accounting for hedged items.

g. Provide guidance or assist management in developing and adapting systems to account for derivative instruments and hedged items under the new standard.

Valuation Consulting Assistance

12. The provision of the following services would not impair the auditor's independence:

a. Provide guidance or assist in developing the client's own valuation model. The client takes responsibility for the model, by testing, evaluating, approving, and running it.

b. Provide guidance on the nature of relevant model inputs (volatility, yield curves, etc.) and related market sources of information. The client makes the final decision as to the inputs and market sources of information to be used.

c. Validate client or third-party models used.

d. Validate reasonableness of inputs to models (client assumptions).

e. Provide a generic/standardized product (e.g., not unlike a Black-Scholes or binomial software model used for valuing options), which a client uses in valuing its derivative instruments. A generic or standardized product is one in which formulas are well-established and subject to only minor judgments or interpretations. It is reasonable to expect that the result produced by such a product will be similar to the result that would be produced by another vendor's product.

13. The provision of the following services would impair the auditor's independence:

a. Compute derivative values using either auditor or client-provided assumptions and a firm-developed, or third party model approved by the client.

b. Develop or be responsible for key assumptions or inputs for use by the client when it uses any valuation model or product.

c. Provide a firm-developed, non-standardized model (e.g., black box equivalent) which a client uses to value its derivatives. The model's methodology or formulas are not standardized, or assumptions are built into the model such that values produced may differ significantly from those produced by another vendor's models.

14. As mentioned above, the overarching principles underlying this interpretation are that the auditor cannot be placed in the position of "auditing his or her own work," or accepting responsibility for the choices and judgments inherent in the preparation of the financial statements such that the auditor is acting as a member of management.

ISB Interpretation 00-1

The Applicability of ISB Standard No. 1 When "Secondary Auditors" Are Involved in the Audit of a Registrant

[This section was superseded, effective September 30, 2008, by Rule 3526. See PCAOB Release No. 2008-003.]

ISB Interpretation 00-2

The Applicability of ISB Standard No. 1 When "Secondary Auditors" Are Involved in the Audit of a Registrant: An Amendment of Interpretation 00-1

[This section was superseded, effective September 30, 2008, by Rule 3526. See PCAOB Release No. 2008-003.]

ISB TOPICAL INDEX

References are to ISB section and paragraph numbers.

QC
QUALITY CONTROL

TABLE OF CONTENTS

QC Section 20

System of Quality Control for a CPA Firm's Accounting and Auditing Practice

(Supersedes sections 10 and 10-1)

Effective date: Applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 1997, unless otherwise indicated.

Statements on Quality Control Standards are issued by the Auditing Standards Board. Firms that are enrolled in an Institute-approved practice-monitoring program are obligated to adhere to quality control standards established by the Institute.

Introduction and Applicability

.01 This section provides that a CPA firm shall have a system of quality control for its accounting and auditing practice and describes elements of quality control and other matters essential to the effective design, implementation, and maintenance of the system.

.02 The AICPA Principles of Professional Conduct provide, among other things, that "members should practice in firms that have in place internal quality-control procedures to ensure that services are competently delivered and adequately supervised."[1] Because of the public interest in the services provided by and the reliance placed on the objectivity and integrity of CPAs, this section provides that a CPA firm shall have a system of quality control for its accounting and auditing practice.[2]

System of Quality Control

.03 A firm[3] as a responsibility to ensure that its personnel[4] comply with the professional standards applicable to its accounting and auditing practice. A system of quality control is broadly defined as a process to provide the firm with reasonable assurance that its personnel comply with applicable professional

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[1] AICPA Code of Professional Conduct, "Article VI—Scope and Nature of Services".

[2] *Accounting and auditing practice* refers to all audit, attest, accounting and review, and other services for which standards have been established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under rule 201 or 202 of the AICPA Code of Professional Conduct. Standards may also be established by other AICPA senior technical committees; engagements that are performed in accordance with those standards are not encompassed in the definition of an accounting and auditing practice.

[3] A *firm* is defined in the AICPA Code of Professional Conduct as "a form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council that is engaged in the practice of public accounting, including the individual owners thereof".

[4] The term *personnel* refers to all individuals who perform professional services for which the firm is responsible, whether or not they are CPAs.

standards and the firm's standards of quality.[5] The policies and procedures designed to implement the system in one segment of a firm's practice may be the same as, different from, or interrelated with the policies and procedures designed for another segment, but the purpose of the system is the same for all segments of a firm's practice.

.04 A firm's system of quality control encompasses the firm's organizational structure and the policies adopted and procedures established to provide the firm with reasonable assurance of complying with professional standards. The nature, extent, and formality of a firm's quality control policies and procedures should be appropriately comprehensive and suitably designed in relation to the firm's size, the number of its offices, the degree of authority allowed its personnel and its offices, the knowledge and experience of its personnel, the nature and complexity of the firm's practice, and appropriate cost-benefit considerations.

.05 Any system of quality control has inherent limitations that can reduce its effectiveness. Variance in an individual's performance and understanding of (*a*) professional requirements or (*b*) the firm's quality control policies and procedures affects the degree of compliance with a firm's prescribed quality control policies and procedures and, therefore, the effectiveness of the system.

.06 The system of quality control should provide the firm with reasonable assurance that the segments of the firm's engagements performed by its foreign offices or by its domestic or foreign affiliates or correspondents are performed in accordance with professional standards in the United States when such standards are applicable.

Quality Control Policies and Procedure

Elements of Quality Control

.07 The quality control policies and procedures applicable to a firm's accounting and auditing practice should encompass the following elements:

a. Independence, Integrity, and Objectivity
b. Personnel Management
c. Acceptance and Continuance of Clients and Engagements
d. Engagement Performance
e. Monitoring

.08 The elements of quality control are interrelated. For example, the maintenance of *Integrity, Objectivity*, and, where required, *Independence* requires a continuing assessment of client relationships. Similarly, the element of *Personnel Management* encompasses criteria for professional development, hiring, advancement, and assignment of the firm's personnel to engagements, which affect policies and procedures developed to meet the objectives of the quality control element of *Engagement Performance*. Similarly, policies and procedures for the quality control element of *Monitoring* are established to provide the firm with reasonable assurance that the policies and procedures related to each of the other elements of quality control are suitably designed and are being effectively applied.

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[5] Deficiencies in individual audit, attest, review, and compilation engagements do not, in and of themselves, indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that its personnel comply with applicable professional standards. [Footnote added, effective September 2002, by Statement on Quality Control Standards No. 6.]

Independence, Integrity, and Objectivity

.09 Policies and procedures should be established to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances,[6] perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.

.10 *Independence, Integrity,* and *Objectivity* are defined and more fully described in the AICPA Code of Professional Conduct (the Code) and AU section 220, *Independence*. Rules 101 and 102 of the Code, and the related Interpretations and Rulings [ET sections 101, 102, and 191) contain examples of instances wherein a member's independence, integrity, and objectivity will be considered to be impaired. *Independence* encompasses an impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to those who may otherwise use the firm's report. The firm and its personnel must be free from any obligation to or interest in the client, its management, or its owners.[7] Integrity requires personnel to be honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. *Objectivity* is a state of mind and a quality that lends value to a firm's services. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.

Personnel Management

.11 A firm's quality control system depends heavily on the proficiency of its personnel. In making assignments, the nature and extent of supervision to be provided should be considered. Generally, the more able and experienced the personnel assigned to a particular engagement, the less direct supervision is needed.

.12 The quality of a firm's work ultimately depends on the integrity, objectivity, intelligence, competence, experience, and motivation of personnel who perform, supervise, and review the work. Thus, a firm's personnel management policies and procedures factor into maintaining such quality.

.13 *Personnel Management* encompasses hiring, assigning personnel to engagements, professional development, and advancement activities. Accordingly, policies and procedures should be established to provide the firm with reasonable assurance that—

a. Those hired possess the appropriate characteristics to enable them to perform competently.

b. Work is assigned to personnel having the degree of technical training and proficiency required in the circumstances.

c. Personnel participate in general and industry-specific continuing professional education and other professional development activities that enable them to fulfill responsibilities assigned, and

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[6] Independence requirements are set forth in Rule 101 of the AICPA Code of Professional Conduct [ET section 101] and the rules of applicable regulatory agencies such as state boards of accountancy, the Securities and Exchange Commission, the U.S. General Accounting Office, and the U.S. Department of Labor. [Footnote renumbered by the issuance of Statement on Quality Control Standards No. 6, September 2002.]

[7] See AU section 220.02. [Footnote renumbered by the issuance of Statement on Quality Control Standards No. 6, September 2002.]

satisfy applicable continuing professional education requirements of the AICPA and regulatory agencies.[8]

d. Personnel selected for advancement have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume.

Acceptance and Continuance of Clients and Engagements

.14 Policies and procedures should be established for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client. Such policies and procedures should provide the firm with reasonable assurance that the likelihood of association with a client whose management lacks integrity is minimized. Establishing such policies and procedures does not imply that a firm vouches for the integrity or reliability of a client, nor does it imply that a firm has a duty to any person or entity but itself with respect to the acceptance, rejection, or retention of clients. However, prudence suggests that a firm be selective in determining its client relationships and the professional services it will provide.

.15 Such policies and procedures should also provide reasonable assurance that the firm—

a. Undertakes only those engagements that the firm can reasonably expect to be completed with professional competence.

b. Appropriately considers the risks associated with providing professional services in the particular circumstances.

.16 To minimize the risk of misunderstandings regarding the nature, scope, and limitations of the services to be performed, policies and procedures should provide for obtaining an understanding with the client regarding those services. Professional standards may provide guidance in deciding whether the understanding should be oral or written.

Engagement Performance

.17 Policies and procedures should be established to provide the firm with reasonable assurance that the work performed by engagement personnel meets applicable professional standards, regulatory requirements, and the firm's standards of quality.

.18 *[The following paragraph is effective for engagement quality reviews of audits and interim reviews for fiscal years beginning on or after December 15, 2009. See PCAOB Release 2009-004.]*

Policies and procedures for *Engagement Performance* encompass all phases of the design and execution of the engagement. To the extent appropriate and as required by applicable professional standards, these policies and procedures should cover planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement. These policies and procedures also should address engagement quality reviews pursuant to PCAOB Auditing Standard No. 7, *Engagement Quality Review*.

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[8] Regulatory agencies that have established continuing education requirements include state boards of accountancy and the U.S. General Accounting Office. [Footnote renumbered by the issuance of Statement on Quality Control Standards No. 6, September 2002.]

.19 Policies and procedures should also be established to provide reasonable assurance that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues). Individuals consulted should have appropriate levels of knowledge, competence, judgment, and authority. The nature of the arrangements for consultation depends on a number of factors, including the size of the firm and the levels of knowledge, competence, and judgment possessed by the persons performing the work.

Monitoring

.20 Policies and procedures should be established to provide the firm with reasonable assurance that the policies and procedures established by the firm for each of the other elements of quality control described in paragraphs .07 through .19 are suitably designed and are being effectively applied.[9] Monitoring involves an ongoing consideration and evaluation of the—

a. Relevance and adequacy of the firm's policies and procedures.

b. Appropriateness of the firm's guidance materials and any practice aids.

c. Effectiveness of professional development activities.

d. Compliance with the firm's policies and procedures. When monitoring, the effects of the firm's management philosophy and the environment in which the firm practices and its clients operate should be considered.

Administration of a Quality Control System

.21 To provide reasonable assurance that the firm's quality control system achieves its objectives, appropriate consideration should be given to the assignment of quality control responsibilities within the firm, the means by which quality control policies and procedures are communicated, and the extent to which the policies and procedures and compliance therewith should be documented.

Assignment of Responsibilities

.22 Responsibility for the *design* and *maintenance* of the various quality control policies and procedures should be assigned to an appropriate individual or individuals in the firm. In making that assignment, consideration should be given to the proficiency of the individuals, the authority to be delegated to them, and the extent of supervision to be provided. However, all of the firm's personnel are responsible for *complying* with the firm's quality control policies and procedures.

Communication

.23 A firm should communicate its quality control policies and procedures to its personnel in a manner that provides reasonable assurance that those

[9] See section 30, *Monitoring a CPA Firm's Accounting and Auditing Practice*. [Footnote renumbered by the issuance of Statement on Quality Control Standards No. 6, September 2002.]

policies and procedures are understood and complied with. The form and extent of such communications should be sufficiently comprehensive to provide the firm's personnel with an understanding of the quality control policies and procedures applicable to them. In addition, a firm should establish a means of communicating its established quality control policies and procedures, and the changes thereto, to appropriate personnel on a timely basis.

Documentation of Quality Control Policies and Procedures

.24 The size, structure, and nature of the practice of the firm should be considered in determining whether documentation of established quality control policies and procedures is required for effective communication and, if so, the extent of such documentation. For example, documentation of established quality control policies and procedures would generally be expected to be more extensive in a large firm than in a small firm and in a multioffice firm than in a single-office firm. Although communication ordinarily is enhanced if it is in writing, the effectiveness of a firm's system of quality control is not necessarily impaired by the absence of documentation of established quality control policies and procedures.

Documentation of Compliance With Quality Control Policies and Procedures

.25 A firm should prepare appropriate documentation to demonstrate *compliance* with its policies and procedures for the quality control system discussed herein. The form and content of such documentation is a matter of judgment and depends on a number of factors, such as the size of a firm, the number of offices, the degree of authority allowed its personnel and its offices, the nature and complexity of the firm's practice, its organization, and appropriate cost-benefit considerations. Documentation should be retained for a period of time sufficient to enable those performing monitoring procedures and a peer review to evaluate the extent of the firm's compliance with its quality control policies and procedures.

Effective Date

.26 The provisions of this section are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 1997.

QC Section 30

Monitoring a CPA Firm's Accounting and Auditing Practice

Effective date: Applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 1997.

Statements on Quality Control Standards are issued by the Auditing Standards Board. Firms that are enrolled in an Institute-approved practice-monitoring program are obligated to adhere to quality control standards established by the Institute.

Introduction

.01 This section provides guidance on how a CPA firm implements the monitoring element of a quality control system in its accounting and auditing practice.[1]

.02 Section 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, describes *Monitoring* as one of the five elements of quality control. It provides that a CPA firm[2] should establish policies and procedures to provide the firm with reasonable assurance that the policies and procedures relating to each of the other elements of quality control are suitably designed and are being effectively applied. Monitoring involves an ongoing consideration and evaluation of the—

a. Relevance and adequacy of the firm's policies and procedures.

b. Appropriateness of the firm's guidance materials and any practice aids.

c. Effectiveness of professional development activities.

d. Compliance with the firm's policies and procedures.

When monitoring, the effects of the firm's management philosophy and the environment in which the firm practices and its clients operate should be considered.

Monitoring Procedures

.03 Monitoring procedures taken as a whole should enable the firm to obtain reasonable assurance that its system of quality control is effective.

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[1] *Accounting and auditing practice* refers to all audit, attest, accounting and review, and other services for which standards have been established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under rule 201 or 202 of the AICPA Code of Professional Conduct. Standards may also be established by other AICPA senior technical committees; engagements that are performed in accordance with those standards are not encompassed in the definition of an accounting and auditing practice.

[2] A *firm* is defined in the AICPA Code of Professional Conduct as "a form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council that is engaged in the practice of public accounting, including the individual owners thereof".

Procedures that provide the firm with a means of identifying and communicating circumstances that may necessitate changes to or the need to improve compliance with the firm's policies and procedures contribute to the monitoring element. A firm's monitoring procedures may include—

- Inspection procedures. (See paragraphs .04 through .07.)
- Preissuance or postissuance review of selected engagements. (See paragraphs .08 and .09.)
- Analysis and assessment of—
  - — New professional pronouncements.
  - — Results of independence confirmations.
  - — Continuing professional education and other professional development activities undertaken by firm personnel.[3]
  - — Decisions related to acceptance and continuance of client relationships and engagements.
  - — Interviews of firm personnel.
- Determination of any corrective actions to be taken and improvements to be made in the quality control system.
- Communication to appropriate firm personnel of any weaknesses identified in the quality control system or in the level of understanding or compliance therewith.
- Follow-up by appropriate firm personnel to ensure that any necessary modifications are made to the quality control policies and procedures on a timely basis.

.04 Inspection procedures evaluate the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures, and the extent of the firm's compliance with its quality control policies and procedures. Inspection procedures contribute to the monitoring function because findings are evaluated and changes in or clarifications of quality control policies and procedures are considered.

.05 The need for and extent of inspection procedures depends in part on the existence and effectiveness of the other monitoring procedures. Factors to be considered in determining the need for and extent of inspection procedures include, but are not limited to—

- The nature, complexity, and diversity of, and the risks associated with, the firm's practice.
- The firm's size, number of offices, degree of authority allowed its personnel and its offices, and organizational structure.
- The results of recent practice reviews[4] and previous inspection procedures.
- Appropriate cost-benefit considerations.[5]

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[3] The term *personnel* refers to all individuals who perform professional services for which the firm is responsible, whether or not they are CPAs.

[4] Practice reviews include, but are not limited to, peer reviews performed under standards established by the AICPA and reviews conducted by regulatory agencies.

[5] Although appropriate cost-benefit considerations may be considered in determining the need for and extent of inspection procedures, a firm must still effectively *monitor* its practice.

.06 The nature of inspection procedures will vary based on the firm's quality control policies and procedures and the effectiveness and results of other monitoring procedures. The adequacy of and compliance with a firm's quality control system are evaluated by performing such inspection procedures as—

- Review of selected administrative and personnel records pertaining to the quality control elements.
- Review of engagement working papers, reports, and clients' financial statements. (See also paragraphs .08 and .09.)
- Discussions with the firm's personnel.
- Summarization of the findings from the inspection procedures, at least annually, and consideration of the systemic causes of findings that indicate improvements are needed.
- Determination of any corrective actions to be taken or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures.
- Communication of the identified findings to appropriate firm management personnel.
- Consideration of inspection findings by appropriate firm management personnel who should also determine that any actions necessary, including necessary modifications to the quality control system, are taken on a timely basis.

Inspection procedures with respect to the engagement performance element of a quality control system are particularly appropriate in a firm with more than a limited number of management-level individuals[6] responsible for the conduct of its accounting and auditing practice.

.07 Inspection procedures may be performed at a fixed time(s) during the year covering a specified period(s) of time or as part of ongoing quality control procedures, or a combination thereof.

.08 Procedures for carrying out preissuance or postissuance review of engagement working papers, reports, and clients' financial statements by a qualified management-level individual (or by a qualified individual under his or her supervision) may be considered part of the firm's monitoring procedures provided that those performing or supervising such preissuance or postissuance reviews are *not directly associated with the performance of the engagement*. Such preissuance or postissuance review procedures may constitute inspection procedures provided—

a. The review is sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures.

b. Findings of such reviews that may indicate the need to improve compliance with or modify the firm's quality control policies and procedures are periodically summarized, documented, and communicated to the firm's management personnel having the responsibility and authority to make changes in those policies and procedures.

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[6] The term *management-level individual* refers to all owners of a firm and other individuals within the firm with a managerial position as described in Interpretation 101-9 of the Code of Professional Conduct.

c. The firm's management personnel consider on a timely basis the systemic causes of findings that indicate improvements are needed and determine appropriate actions to be taken.

d. The firm implements on a timely basis such planned actions, communicates changes to personnel who might be affected, and follows up to determine that the planned actions were taken.

A preissuance and, except as described in paragraph .09, a postissuance review of engagement working papers, reports, and clients' financial statements by the person with final responsibility for the engagement does not constitute a monitoring procedure.

.09 In small firms with a limited number of qualified management-level individuals, postissuance review of engagement working papers, reports, and clients' financial statements by the person with final responsibility for the engagement may constitute inspection procedures, provided the provisions in paragraph .08*a–d* are followed. (See also paragraph .11.)

Monitoring in Small Firms With a Limited Number of Management-Level Individuals

.10 In small firms with a limited number of management-level individuals, monitoring procedures may need to be performed by some of the same individuals who are responsible for compliance with the firm's quality control policies and procedures. To effectively monitor one's own compliance with the firm's policies and procedures, an individual must be able to critically review his or her own performance, assess his or her own strengths and weaknesses, and maintain an attitude of continual improvement. Changes in conditions and in the environment within the firm (such as obtaining clients in an industry not previously serviced or significantly changing the size of the firm) may indicate the need to have quality control policies and procedures monitored by another qualified individual.

.11 The performance of inspection procedures in firms with a limited number of management-level individuals can assist the firm in the monitoring process. An individual inspecting his or her own compliance with a quality control system may be inherently less effective than having such compliance inspected by another qualified individual. When one individual inspects his or her own compliance, the firm may have a higher risk that noncompliance with policies and procedures will not be detected. Accordingly, a firm in this circumstance may find it beneficial to engage a qualified individual from outside the firm to perform inspection procedures.

The Relationship of Peer Review to Monitoring

.12 A peer review does not substitute for monitoring procedures. However, since the objective of a peer review is similar to that of inspection procedures, a firm's quality control policies and procedures may provide that a peer review conducted under standards established by the AICPA may substitute for some or all of its inspection procedures for the period covered by the peer review.

Effective Date

.13 The provisions of this section are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 1997.

QC Section 40

The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement

Introduction

.01 Section 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, provides that a CPA firm shall have a system of quality control for its accounting and auditing practice[1] that should encompass the following elements:

a. Independence, integrity, and objectivity
b. Personnel management
c. Acceptance and continuance of clients and engagements
d. Engagement performance
e. Monitoring

The Personnel Management Element of Quality Control

.02 *Personnel Management* encompasses hiring, assigning personnel to engagements, professional development, and advancement activities. Accordingly, policies and procedures should be established to provide the firm with reasonable assurance that—

a. Those hired possess the appropriate characteristics to enable them to perform competently. Examples of such characteristics may include meeting minimum academic requirements established by the firm, maturity, integrity, and leadership traits.

b. Work is assigned to personnel having the degree of technical training and proficiency required in the circumstances.

c. Personnel participate in general and industry-specific continuing professional education and other professional development activities that enable them to fulfill responsibilities assigned, and satisfy applicable continuing professional education requirements of the AICPA, and regulatory agencies.[2]

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[1] *Accounting and auditing practice* refers to all accounting, audit, and attestation services for which standards have been established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under Rule 201 or 202 of the AICPA Code of Professional Conduct. Standards may also be established by other AICPA senior technical committees; engagements that are performed in accordance with those standards are not encompassed in the definition of an accounting, auditing, and attestation practice.

[2] Regulatory agencies that have established continuing education requirements include state boards of accountancy and the U.S. General Accounting Office.

d. Personnel selected for advancement have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume.

.03 This section clarifies the requirements of the personnel management element of a firm's system of quality control. In light of the significant responsibilities during the planning and performance of accounting, auditing, and attestation engagements of individuals who are responsible for supervising accounting, auditing, and attestation engagements and signing or authorizing an individual to sign the accountants report on such engagements, a firm's policies and procedures related to the items noted in paragraph .02 above should be designed to provide a firm with reasonable assurance that such individuals possess the kinds of competencies that are appropriate given the circumstances of individual client engagements. For purposes of this standard, such an individual is referred to as the practitioner-in-charge of the engagement.

Competencies

.04 Competencies are the knowledge, skills, and abilities that enable a practitioner-in-charge to be qualified to perform an accounting, auditing, or attestation engagement. A firm is expected to determine the kinds of competencies that are necessary in the individual circumstances. Competencies are not measured by periods of time because such a quantitative measurement may not accurately reflect the kinds of experiences gained by a practitioner in any given time period. Accordingly, for purposes of this section, a measure of overall competency is qualitative rather than quantitative.

Gaining Competencies

.05 A firm's policies and procedures would ordinarily require a practitioner-in-charge of an engagement to gain the necessary competencies through recent experience in accounting, auditing, and attestation engagements. In some cases, however, a practitioner-in-charge will have obtained the necessary competencies through disciplines other than the practice of public accounting, such as in relevant industry, governmental, and academic positions. If necessary, the experience of the practitioner-in-charge should be supplemented by continuing professional education (CPE) and consultation. The following are examples.

- A practitioner-in-charge of an engagement whose recent experience has consisted primarily in providing tax services may acquire the competencies necessary in the circumstances to perform a compilation or review engagement by obtaining relevant CPE.
- A practitioner-in-charge of an engagement who did not have any experience in auditing the financial statements of a public company and only possessed recent prior experience in auditing the financial statements of nonpublic entities may develop the necessary competencies by obtaining relevant CPE related to SEC rules and regulations and consulting with other practitioners who possess relevant knowledge related to SEC rules and regulations.
- A practitioner-in-charge of an engagement who did not have any experience in auditing the financial statements of a public company but possessed prior public accounting practice experience auditing financial statements of nonpublic entities and who also has relevant experience as the controller of a public company may have the necessary competencies in the circumstances.

- A practitioner-in-charge of an engagement whose actual experience consists of performing review and compilation engagements may be able to obtain the necessary competencies to perform an audit by becoming familiar with the industry in which the client operates, obtaining continuing professional education relating to auditing, and/or using consulting sources during the course of performing the audit engagement
- A person in academia might obtain the necessary competencies to perform accounting, auditing or attestation engagements by (*a*) obtaining specialized knowledge through teaching or authorship of research projects or similar papers, and (*b*) a rigorous self-study program or by engaging a consultant to assist on such engagements.

.06 Regardless of the manner in which a particular competency is gained, a firm's quality control policies and procedures should be adequate to provide reasonable assurance that a practitioner-in-charge of an engagement possesses the competencies necessary to fulfill his or her engagement responsibilities.

.07 The nature and extent of competencies established by a firm that are expected of the practitioner-in-charge of an engagement should be based on the characteristics of a particular client, industry, and the kind of service being provided. For example, the following should be considered.

- The competencies expected of a practitioner-in-charge of an engagement to compile financial statements would be different than those expected of a practitioner engaged to review or audit financial statements.
- Supervising engagements and signing or authorizing others to sign reports for clients in certain industries or engagements, such as financial services, governmental, or employee benefit plan engagements, would require different competencies than what would be expected in performing attest services for clients in other industries.
- The practitioner-in-charge of an engagement to audit the financial statements of a public company would be expected to have certain technical proficiency in SEC reporting requirements, while a practitioner-in-charge who is not assigned to the audits of public companies would not need to be proficient in this area. This would include, for example, experience in the industry and appropriate knowledge of SEC and ISB rules and regulations, including accounting and independence standards.
- The practitioner-in-charge of an attestation engagement to examine management's assertion about the effectiveness of an entity's internal control over financial reporting would be expected to have certain technical proficiency in understanding and evaluating the effectiveness of controls, while a practitioner-in-charge of an attestation engagement to examine investment performance statistics would be expected to have different competencies, including an understanding of the subject matter of the underlying assertion.

Competencies Expected in Performing Accounting, Auditing, and Attestation Engagements

.08 In practice, the kinds of competency requirements that a firm should establish for the practitioner-in-charge of an engagement are necessarily broad

and varied in both their nature and number. However, the firm's quality control policies and procedures should ordinarily address the following competencies for the practitioner-in-charge of an engagement. Firms policies and procedures should also address other competencies as necessary in the circumstances.

- *Understanding of the Role of a System of Quality Control and the Code of Professional Conduct*—Practitioners-in-charge of an engagement should possess an understanding of the role of a firm's system of quality control and the AICPA's Code of Professional Conduct, both of which play critical roles in assuring the integrity of the various kinds of accountant's reports.
- *Understanding of the Service to be Performed*—Practitioners-in-charge of an engagement should possess an understanding of the performance, supervision, and reporting aspects of the engagement, which is normally gained through actual participation in that kind of engagement under appropriate supervision.
- *Technical Proficiency*—Practitioners-in-charge of an engagement should possess an understanding of the applicable accounting, auditing, and attest professional standards including those standards directly related to the industry in which a client operates and the kinds of transactions in which a client engages.
- *Familiarity with the Industry*—To the extent required by professional standards applicable to the kind of service being performed, practitioners-in-charge of an engagement should possess an understanding of the industry in which a client operates. In performing an audit or review of financial statements, this understanding would include an industry's organization and operating characteristics sufficient to identify areas of high or unusual risk associated with an engagement and to evaluate the reasonableness of industry specific estimates.
- *Professional Judgment*—Practitioners-in-charge of an engagement should possess skills that indicate sound professional judgment. In performing an audit or review of financial statements, such skills would typically include the ability to exercise professional skepticism and identify areas requiring special consideration including, for example, the evaluation of the reasonableness of estimates and representations made by management and the determination of the kind of report necessary in the circumstances.
- *Understanding the Organization's Information Technology Systems*—Practitioners-in-charge of an audit engagement should have an understanding of how the organization is dependent on or enabled by information technologies; and the manner in which information systems are used to record and maintain financial information.

Interrelationship of Competencies and Other Elements of a Firm's System of Quality Control

.09 The competencies listed above are interrelated and gaining one particular competency may be related to achieving another. For example, familiarity with the client's industry interrelates with a practitioner's ability to make professional judgments relating to the client.

.10 In establishing policies and procedures related to the nature of competencies needed by the practitioner-in-charge of an engagement, a firm may

need to consider the requirements of policies and procedures established for other elements of quality control. For example, a firm would consider its requirements related to engagement performance in determining the nature of any competency requirements that assess the degree of technical proficiency necessary in a given set of circumstances.

The Relationship of the Competency Requirement of the Uniform Accountancy Act to the Personnel Management Element of Quality Control

.11 The Uniform Accountancy Act (UAA) is a model legislative statute and related administrative rules that the AICPA and the National Association of State Boards of Accountancy (NASBA) designed to provide a uniform approach to the regulation of the accounting profession. CPAs are not required to follow the provisions of the UAA itself but rather the accountancy laws of the individual licensing jurisdictions in the United States governing the practice of public accounting, which may have adopted the UAA in whole or in part. The UAA provides that "any individual licensee who is responsible for supervising attest or compilation services and signs or authorizes someone to sign the accountant's report on the financial statements on behalf of the firm shall meet the competency requirements set out in the professional standards for such services." A firm's compliance with this section is intended to enable a practitioner who performs the services described in the preceding sentence on the firm's behalf to meet this competency requirement; however, this section's applicability is broader than what is required by the UAA since the definition of an accounting and auditing practice in quality control standards encompasses a wider range of attest engagements.

Effective Date

.12 The provisions of this section are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of June 30, 2000. Earlier implementation is encouraged.

QC TOPICAL INDEX

References are to QC section and paragraph numbers.

SECPS
SEC PRACTICE SECTION (SECPS)

TABLE OF CONTENTS

SECPS Section 1000.08(d), (f), (l), (m), (n), (o)
Requirements of Membership

Continuing Professional Education of Audit Firm Personnel

.08(d) Ensure that all professionals in the firm residing in the United States, including CPAs and non-CPAs, participate in at least 20 hours of qualifying continuing professional education (CPE) every year and at least 120 hours every three years. Effective for CPE years beginning on or after January 1, 1995, professionals who devote at least 25% of their time to performing audit, review or other attest engagements (excluding compilations), or who have the partner/manager-level responsibility for the overall supervision or review of any such engagements, must obtain at least 40% (eight hours in any one year and 48 hours every three years) of their required CPE in subjects relating to accounting and auditing. The term accounting and auditing subjects should be broadly interpreted, and for example, include subjects relating to the business or economic environments of the entities to which the professional is assigned.[1]

Concurring Partner Review of the Audit Report and the Financial Statements of Commission Registrants

.08(f) *[This section was superseded, effective for engagement quality reviews of audits and interim reviews for fiscal years beginning on or after December 15, 2009, by PCAOB Auditing Standard No. 7. See PCAOB Release No. 2009-004.]*[2]

Communication by Written Statement to all Professional Personnel of Firm Policies and Procedures on the Recommendation and Approval of Accounting Principles, Present and Potential Client Relationships, and the Types of Services Provided

.08(l) Communicate through a written statement to all professional firm personnel the broad principles that influence the firm's quality control and operating policies and procedures on, as a minimum, matters related to the recommendation and approval of accounting principles, present and potential client relationships, and the types of services provided, and inform professional

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[1] See SECPS §8000 for additional information about the continuing professional education requirement and the manner in which compliance is to be measured.

[2] *[This footnote was superseded, effective for engagement quality reviews of audits and interim reviews for fiscal years beginning on or after December 15, 2009, by PCAOB Auditing Standard No. 7. See PCAOB Release No. 2009-004.]*

firm personnel periodically that compliance with those principles is mandatory.[3] (Appendix H, SECPS §1000.42 is an illustration of such a statement.)

Notification of the Commission of Resignations and Dismissals from Audit Engagements for Commission Registrants

.08(m) When the member firm has been the auditor for an SEC registrant (as defined in Appendix D, SECPS §1000.38) and has resigned, declined to stand for re-election or been dismissed, report the fact that the client-auditor relationship has ceased directly in writing to the former SEC client, with a simultaneous copy to the Office of the Chief Accountant of the Securities and Exchange Commission.[4] Such report shall be sent to the former SEC client and to the Office of the Chief Accountant by the end of the fifth business day following the member firm's determination that the client-auditor relationship has ended, irrespective of whether or not the registrant has reported the change in auditors in a timely filed Form 8-K.

Audit Firm Obligations with Respect to the Policies and Procedures of Correspondent Firms and of Other Members of International Firms or International Associations of Firms

.08(n) For SECPS member firms that are members of, correspondents with, or similarly associated with international firms or international associations of firms, seek adoption of policies and procedures by the international organization or individual foreign associated firms[5] that are consistent with the objectives set forth in Appendix K, SECPS §1000.45 for SEC registrants.[6]

Policies and Procedures to Comply with Independence Requirements

.08(o) Ensure that the member firm has policies and procedures in place to comply with applicable independence requirements of the AICPA, SEC and Independence Standards Board.[7]

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[3] Firms that become members of the Section shall prepare and issue such a statement within six months of joining the Section.

[4] See Appendix I, SECPS §1000.43, for standard form of such report.

[5] For this purpose, a foreign associated firm is a firm domiciled outside of the United States and its territories that is a member of, correspondent with, or similarly associated with an international association of firms with which the SECPS member is associated.

[6] See Appendix D, SECPS §1000.38, "Revised Definition of an SEC Engagement" for purposes of determining compliance with the membership requirements of SECPS §1000.08e, f, g, h, i, k, m, n, o, and p.

[7] See Appendix L, SECPS §1000.46, "Independence Quality Controls" for purposes of determining compliance with the membership requirement.

SECPS Section 1000.38, .39, .42, .43, .45, .46
Appendixes D, E, H, I, K, L

SECPS Section 1000.38 Appendix D—Revised Definition of an SEC Client

1. For purposes of determining whether a U.S. member firm is required to join the SEC Practice Section (the "Section") and comply with the Section's membership requirements, the Executive Committee has defined an SEC client (which is used interchangeably with SEC audit client, SEC registrant and SEC engagement) as one that involves the audit of the financial statements of the following:[1]

a. An issuer making an initial filing, including amendments, under the Securities Act of 1933 (the "1933 Act") or the Securities Exchange Act of 1934 (the "1934 Act").

b. A registrant that files periodic reports (for example, Forms N-SAR, 10-K or 11-K) with the Securities and Exchange Commission under the Investment Company Act of 1940 or the 1934 Act[2] (except a broker or dealer registered only because of section 15 paragraph a of the 1934 Act).

c. A bank or other lending institution that files periodic reports with the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, or the Office of Thrift Supervision, because the powers, functions, and duties of the SEC to enforce its periodic reporting provisions are vested, pursuant to section 12(i) of the 1934 Act, in those agencies.[3] (The Section's membership requirement §1000.08m does not apply to these entities.)

This definition of an SEC client shall also be used for purposes of determining the number of SEC clients for which a firm is the principal auditor-of-record and, therefore, for which information is required to be filed with the Section for each fiscal year of a U.S. member firm. For this purpose, the Executive Committee has determined that a series of unit investment trusts, series of limited partnerships and series of mutual funds sponsored by the same entity shall be treated as one SEC client. (see SECPS §1000.08g).

2. Only for purposes of implementing the membership requirements of SECPS §1000.08k to report certain litigation, proceedings, or investigations to

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[1] Since the firm need only consider those clients for which it is the principal auditor of record in the current period, for purposes of this definition, subsidiaries or unconsolidated affiliates whose financial information is included in the financial statements or filings of an SEC registrant are not considered SEC clients, unless those subsidiaries or unconsolidated affiliates meet one of the conditions in paragraph 1.

[2] Clients that have only issued securities exempt from registration under Regulations A, D or S should not be considered SEC clients.

[3] Rules 12g-4 and 12h-3 under the 1934 Act provide an exemption from periodic reporting to the SEC for (1) entities with less than $10 million in total assets on the last day of the issuer's three most recent fiscal years and less than 500 shareholders and for (2) entities with less than 300 shareholders. Accordingly, such entities that utilize the exemption are not encompassed within the scope of this definition.

the Quality Control Inquiry Committee, the Executive Committee has determined that the term SEC client, in addition to entities included under paragraph 1 above, shall also include:

a. A subsidiary or investee of an entity encompassed by paragraph 1 above, if such matters relate to financial statements presented separately in parent or investor company filings under the 1933 Act or the 1934 Act.

b. An entity encompassed by paragraph 1 above, if such matters relate to the financial statements of a former client that are included in a 1933 Act or 1934 Act filing.

3. For purposes of implementing the membership requirements of SECPS §1000.08n, the Executive Committee has determined that the term SEC registrant shall also encompass all foreign private issuers defined by Rule 405 of Regulation C under the 1933 Act and Rule 3b-4(C) under the 1934 Act that have securities registered or have filed a registration statement with the SEC.

None of the foregoing is intended to change SECPS §1000.13 of the organizational structure and functions section regarding the appointment of members to the Executive Committee of the Section.

SECPS Section 1000.39 Appendix E—Concurring Partner Review Requirement (Revised with an Effective Date of March 31, 2002)

Statement on Auditing Standards No. 25, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* [AU section 161], and Statement on Quality Control Standards No. 2 (SQCS No. 2), *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* [QC section 20], require the firm to maintain a system of quality control to provide reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality. Engagement performance policies and procedures required by paragraph .18 of SQCS No. 2 [QC section 20.18][1] encompass all phases of a firm's policies and procedures for the design and execution of the engagement, which include the concurring partner review for SEC engagements. Accordingly, the concurring partner review is an integral part of the firm's system of quality control and serves as an objective review of significant auditing, accounting, and financial reporting matters[2] that come to the attention of the concurring partner reviewer and the resolution of such matters prior to the issuance of the firm's audit report with respect to financial statements of SEC engagements (see Appendix D, SECPS §1000.38). On the basis of that review, the concurring partner reviewer should conclude that no matters that have come to his or her attention would cause the concurring partner reviewer to believe that the financial statements are not in conformity with generally accepted accounting principles in all material respects, or that the firm's audit was not performed in accordance with generally accepted auditing standards.

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[1] The Auditing Standards Board has issued a revision to SQCS No. 2 [QC section 20.18], through adoption of SQCS No. 4, to specify "Where applicable, these policies and procedures should also address the AICPA's SEC Practice Section's concurring partner review requirement for SEC engagements."

[2] For purposes of the concurring partner review, "significant auditing, accounting, and financial reporting matters" refers to matters involving a significant risk of material misstatement of financial statements, including a material disclosure deficiency in the footnotes to the financial statements.

A member firm's system of quality control should include policies and procedures covering (*a*) the qualifications of concurring partner reviewers, (*b*) the nature, extent, and timing of the concurring partner review, (*c*) the documentation required to evidence compliance with the firm's policies and procedures with respect to the concurring partner review requirement, and (*d*) quarterly reviews.

As a minimum, the firm's policies and procedures should be responsive to the following:

a. Qualifications. The concurring partner reviewer should have sufficient technical expertise and experience to achieve the purpose described above. The determination of what constitutes sufficient technical expertise and experience requires consideration and is tailored to the circumstances of the engagement, including the personnel assigned to the engagement. An effective concurring partner review contemplates knowledge of relevant specialized industry practices. It also contemplates that the concurring partner reviewer possesses knowledge of SEC rules and regulations in areas where such rules and regulations are pertinent. There are various ways to obtain such knowledge in addition to personal audit experience, such as attendance at relevant training courses and through self-study. The concurring partner reviewer should seek assistance from other individuals to supplement this knowledge when necessary in the circumstances.

The tone set at the top of the firm should encourage and support the performance of objective concurring partner reviews. In this regard, firm policy should state that the concurring partner reviewer is expected to carry out his or her responsibilities with objectivity and due professional care without regard to the relative positions of the audit engagement partner and the concurring partner reviewer.

Further, the concurring partner reviewer should not assume any of the responsibilities of the audit partner-in-charge of the engagement or have responsibility for the audit of any significant subsidiaries, divisions, benefit plans, or affiliated or related entities.[3] In addition, a prior audit engagement partner should not serve as the concurring partner reviewer for at least two annual audits following his or her last year as the audit engagement partner.[4] A member firm that is not subject to the SECPS membership requirement regarding rotation of an audit engagement partner of an SEC engagement after seven consecutive years is exempt from the preceding requirement.[5]

b. Nature, Extent, and Timing. The concurring partner reviewer's responsibility is to perform an objective review of significant

[3] It is not unusual for clients to be aware of the existence of a concurring partner reviewer. A client may contact the concurring partner reviewer with respect to matters requiring immediate attention when the audit engagement partner is not available because of illness, extended travel or other reasons. When a concurring partner reviewer is thus required to deal with an accounting, auditing or financial reporting matter, he or she should advise the audit engagement partner of the facts and circumstances so that the audit engagement partner can review the matter and take full responsibility for its resolution.

[4] The SECPS Peer Review Committee may authorize alternative procedures when this requirement imposes an undue hardship on the firm. See SECPS §2000.147, Appendix F, of the SEC Practice Section Reference Manual for submitting requests for a waiver of this requirement to the SECPS Peer Review Committee.

[5] See SECPS §1000.08(e)(1), "Requirements of Members," of the SEC Practice Section Reference Manual.

auditing, accounting, and financial reporting matters and to conclude, based on all the relevant facts and circumstances of which the concurring partner reviewer has knowledge, that no matters that have come to his or her attention would cause the concurring partner reviewer to believe that the client's financial statements covered by the firm's audit report are not in conformity with generally accepted accounting principles in all material respects or that the audit was not performed in accordance with generally accepted auditing standards.

The concurring partner reviewer's responsibility is not the equivalent of the audit engagement partner's responsibilities. Without first-hand knowledge of the client's business environment, the benefit of discussions with management and other client personnel, the opportunity to review client documents or controls, or the ability to observe the client's actions or attitudes, a concurring partner reviewer generally is not in a position to make the informed judgments on significant issues expected of an audit engagement partner. However, the concurring partner reviewer is expected to objectively perform the procedures specified below and reach conclusions based on all relevant facts and circumstances of which he or she has knowledge.

The concurring partner reviewer's responsibility is fulfilled by performing the following procedures:

- Discussing significant accounting, auditing and financial reporting matters with the audit engagement partner;
- Discussing the audit engagement team's identification and audit of high-risk transactions and account balances;
- Reviewing documentation of the resolution of significant accounting, auditing and financial reporting matters, including documentation of consultation with firm personnel or resources external to the firm's organization (such as standard-setters, regulators, other accounting firms, the AICPA, and state societies);[6]
- Reviewing a summary of unadjusted audit differences;
- Reading the financial statements and auditors' report; and
- Confirming with the audit engagement partner that there are no significant unresolved matters.

These procedures provide the basis for the concurring partner reviewer to perform an objective review of accounting, auditing and financial reporting matters that were considered significant by the engagement team in conducting the audit. The concurring partner reviewer is not responsible for searching for additional matters to be considered by the engagement team. However, significant matters not previously identified by the engagement team that come to the concurring partner reviewer's attention should

[6] Documentation to be reviewed should consist of summary memoranda and/or working paper summaries of the resolution of significant accounting, auditing, and financial reporting matters, and may include selected, more detailed working papers and other documentation. The review of the more detailed working papers and other documentation is a matter of professional judgment made by the concurring partner reviewer about the extent of information necessary to perform an objective review so that he or she has sufficient basis to conclude on the results of the review.

be referred to and resolved by the engagement team with the concurrence of the concurring partner reviewer.

In addition to performing the procedures described in the bullets above, the concurring partner reviewer's consideration and conclusions about whether significant matters were appropriately considered and resolved may require discussions with other firm personnel involved in any significant consultations. When discussion occurs with the concurring partner reviewer on an accounting, auditing or financial reporting matter during the engagement, the audit engagement partner ordinarily should develop an initial resolution to the matter before discussion with the concurring partner reviewer.[7]

The firm's guidelines for concurring partner review should take into account its policies and procedures for planning, supervising and reviewing engagements, and the extent to which those policies provide for the documentation of significant accounting, auditing, and financial reporting matters. The firm's guidelines also should identify the types of engagements for which a timely review should be made of the audit planning by the concurring partner reviewer so that any modifications can be implemented effectively during the performance of the audit. Firms should apply, as a minimum, this procedure to the firm's initial audit of a SEC engagement and other high-risk engagements as defined by the firm for this purpose. Such a definition might be influenced by the complexity of the entity, the engagement personnel's experience with the entity, and their knowledge of the entity's business. Factors to consider in this regard may include the entity's type of business; types of products and services; capital structure; related parties; locations; production, distribution, and compensation methods; any material changes in the entity's business; and whether the entity has plans for a public offering. (See AICPA Professional Standards, Vol. 1, AU section 311, "Planning and Supervision" and AU section 312, "Audit Risk and Materiality in Conducting an Audit.")

If the concurring partner reviewer and the audit engagement partner of the engagement have conflicting views regarding important matters, the disagreement should be resolved in accordance with applicable firm policy.[8]

In all cases, the concurring partner review should be completed before the release of the audit report and before the re-issuance of the audit report where performance of subsequent events procedures[9] is required by professional standards.

c. Documentation. The engagement files should contain evidence that the firm's policies and procedures with respect to the concurring partner review requirement were complied with before the issuance of the firm's audit report. Ordinarily, this would include documentation that the concurring partner reviewer has performed the procedures specified by the firm's policies and that

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[7] Discussion with the concurring partner reviewer is most effective when the concurring partner reviewer is aware of and understands the issues at the time the issues are addressed by the audit engagement team rather than addressing the issues at the conclusion of the engagement.

[8] See Statement on Auditing Standards No. 22, "Planning and Supervision" [AU section 311].

[9] In this instance, the concurring partner reviewer ordinarily would concern himself or herself with matters relating to the subsequent events procedures.

no matters that have come to the attention of the concurring partner reviewer would cause him or her to believe that the financial statements are not in conformity with generally accepted accounting principles in all material respects or that the firm's audit was not performed in accordance with generally accepted auditing standards.

d. Quarterly Reviews. Items (*b*) and (*c*) above relate to the concurring partner reviewer's involvement with an audit engagement. For a review conducted in accordance with SAS No. 71, "Interim Financial Information," on financial statements in an SEC client's quarterly Form 10-Q or 10-QSB filing, a member firm's policies and procedures should require discussion with the concurring partner reviewer, prior to the completion of the review, about any matters identified in the review that involve a significant risk of material misstatement of the financial statements.[10] Any such involvement should be documented.

SECPS Section 1000.42 Appendix H—Illustrative Statement of Firm Philosophy

The Firm and Its Objectives

ABC & Co. is a partnership engaged in the practice of public accounting in Anytown and Everywhere. ABC & Co. maintains correspondent relationships with selected firms that enable us to meet client needs for services outside our normal practice area.

We have as an overriding objective the provision of high quality audit, accounting, tax, and advisory services to clients in the best professional manner. Our partners and staff are expected to comply with this statement of philosophy in order to achieve that objective.

"Professionalism" in the accounting profession means integrity, objectivity, independence where required, adherence to professional standards and applicable laws and regulations, and a demonstrated will to maintain and improve the quality of professional services and to withstand all pressures, competitive and otherwise, to compromise on principles, standards, and quality. In the field of auditing, particularly, professionalism requires an understanding of and dedication to the public interest.

The public interest in audited financial statements has placed the public accounting profession in a unique position of public trust. Moreover, there is also a significant public interest in the way in which the Firm carries out accounting, tax, and advisory services. Therefore, no client or Firm consideration is allowed to interfere with our ability to carry out our commitment to professionalism.

Professional Performance

ABC & Co. demands integrity, objectivity, competence, and due care from all of its personnel in the conduct of all of its engagements, whatever their nature. We demand independence in fact and appearance in all audit and other engagements where independence is required by applicable laws and regulations and

[10] For purposes of the concurring partner review, "significant risk of material misstatement of the financial statements" includes a material disclosure deficiency in the footnotes to the financial statements.

the requirements of professional societies. We take steps to insure that personnel assigned to engagements, whatever their nature, have the professional and specialized knowledge required to carry out their responsibilities; at the same time, we recognize that supervisors and other reviewers and consultants can complement that knowledge.

Our Firm is structured to provide leadership in achieving high quality professional performance while maintaining the concept of individual responsibility so necessary to clients and to individuals within the firm. ABC & Co. has established policies and procedures that we believe provide assurance that professional engagements are properly planned and executed and that decisions are based on the substance of issues, not on form. Accounting standards cannot deal with all possible situations, and we at all times urge our clients to adopt accounting and reporting policies that we believe are the most appropriate in the circumstances.

Our policies and procedures provide, among other things, for consultation on significant matters, and ABC & Co. has designated partners of the Firm whose opinions are to be sought on significant ethical, technical, and industry questions. The policies and procedures we have established are designed to assure that our clients receive the best professional services we can provide and that in providing those services we continually keep in mind the public interest in our work. We expect our partners and staff to identify and resolve all important issues relevant to an engagement.

More specifically, to achieve high quality professional performance, and to comply with the membership requirements of the AICPA Division for CPA Firms, ABC & Co. has adopted policies and procedures that implement the quality control standards for the conduct of accounting and auditing engagements established by the American Institute of Certified Public Accountants. Those policies and procedures relate to the following elements of quality control, among other matters:

Independence, Integrity, and Objectivity—To be free from financial, business, family, and other relationships involving a client when required. To be honest and candid within the constraints of client confidentiality. To have a state of mind and a quality that lends value to the firms services and imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.

Personnel Management—To hire individuals that possess the appropriate characteristics to enable them to perform competently. To assign work to personnel who possess the technical training and competence required in the circumstances. To provide personnel with the training necessary to fulfill responsibilities assigned and satisfy applicable continuing professional education requirements. To select for advancement those individuals that have the qualifications necessary to fulfill responsibilities involved.

Acceptance and Continuance of Clients and Engagements—To appropriately consider the risks associated with providing professional services so as to decrease the likelihood of association by the firm with clients and engagements in which client management lacks integrity. To associate with clients and engagements in which the firm can reasonably expect to complete with professional competence.

Engagement Performance—To determine that the design and execution of work performed is efficient and in accordance with applicable professional standards. To have personnel refer to authoritative literature or other sources and consult with individuals with the knowledge, technical competency, judgment, and authority, when appropriate.

> ***Monitoring***—To develop a system to evaluate on an ongoing basis whether the other elements of quality control established by the firm are suitably designed and are being effectively applied.

We have also adopted appropriate policies and procedures in the above areas to guide the conduct of tax and advisory services engagements.

The adequacy of the Firm's quality control system for our accounting and auditing practice and our compliance with that system are independently evaluated every three years through a peer review conducted under the auspices of the AICPA Division for CPA Firms. The peer review report is available to our clients and other interested parties.

Relationships With Clients

The value of our services is, to a large degree, dependent on the public perception of our integrity and objectivity. If the public were to doubt our integrity or objectivity—or our competence or professional care—as a result of our work for a given client, the value of our services to that client, to all other clients, and to the public at large could drop significantly. Accordingly, just as our clients are selective in their choice of CPA firms, ABC & Co. is selective in accepting clients. Our responsibilities to existing clients and to the public demand that we consider the appropriateness of client relationships and that we carefully consider the nature of services we are asked to provide and our ability to provide those services in a quality manner in conformity with all relevant professional standards.

When potential clients who disagree with their present auditors on significant auditing, accounting, or reporting questions, request our opinion on the matter, we consult within our Firm and with a potential client's present or predecessor CPA firm before giving our final conclusion on the matter.

We value our reputation for quality services and believe that reputation is the basis on which we attract new clients and build our practice for the future. We are committed to rendering value for our fees and believe our clients should have a reasonable basis for making that judgment for themselves. Accordingly, we carefully evaluate the services we are asked to provide and the factors, such as the nature of control systems and procedures, that will affect the costs we expect to incur in providing such services before we inform present and potential clients of the fees we estimate those services will entail. Once ABC & Co. undertakes a client engagement, we bring all the resources to that engagement necessary in the circumstances.

We do not disclose to anyone outside of our Firm any confidential client information obtained in the course of any engagement unless the disclosure is authorized by the client or is required to discharge properly our responsibilities under law or authoritative regulatory or professional standards. (Our peer reviewers have access to client information, but they are bound by the same standards of confidentiality).

Services Provided

ABC & Co. provides a full range of audit, accounting, tax, and advisory services, consistent with ethical and professional standards and regulatory requirements in the United States and with the limitations imposed by our Firm's membership in the AICPA Division for CPA Firms.

The services provided by CPA firms must be responsive to changes in the environment, which is affected by developments in information technology, the

increasing complexity of tax laws and regulations, greater demands by the public for new types of information and CPA assurances on such information, the increasing need of many clients for advisory services, and a host of other factors.

If the public accounting profession as a whole, and ABC & Co. in particular, are to meet the legitimate and changing needs of clients and the public, arbitrary restrictions on the services provided are not appropriate. However, ABC & Co., as a matter of policy, will undertake only engagements that we believe we can perform with competence, that will be useful to our clients or to appropriate third parties, that will not impair our independence in fact or appearance when we also provide audit services to the client involved, and that will help attract and retain the personnel we need to provide the knowledge base essential to maintain our ability to serve our clients and the public in a professional manner. In evaluating proposed engagements, as well as the way we inform clients and others of our capabilities, we consider whether such engagements will lessen public confidence in our independence, integrity, and objectivity in the performance of the audit function or in our commitment to that function.

SECPS Section 1000.43 Appendix I—Standard Form of Letter Confirming the Cessation of the Client-Auditor Relationship

(Date)

Mr. John Doe
Chief Financial Officer
XYZ Corporation
Anytown, USA

Dear Mr. Doe:

This is to confirm that the client-auditor relationship between XYZ Corporation (Commission File Number X-XXXX) and Able Baker & Co. has ceased.

Sincerely,

_____
Able Baker & Co.

CC: Office of the Chief Accountant
SECPS Letter File
Securities and Exchange Commission
Mail Stop 9-5
450 Fifth Street, N.W.
Washington, D.C. 20549

NOTE: The SEC has indicated that member firms may satisfy the SECPS notification requirements by faxing a copy of the SECPS letter to the SEC-Office of the Chief Accountant (202-942-9656; Attn: SECPS Letter File/Mail Stop 9-5). A copy of the fax log should be retained by the sender as documentation of timely filing and a back-up copy of the letter should be sent by regular mail to the SEC. The SEC strongly encourages sending the notification letter by fax and will accept the date of the fax as the notification date. If a fax transmission is not available, alternatively, by order of preference, the SECPS notification

letter may be sent to the SEC via (1) U.S. Postal Service overnight delivery, (2) commercial overnight courier, or (3) certified mail, "return receipt requested".

The exact name of the registrant, the Commission File Number as it appears on the cover page of the Form 10-K, and the complete SEC address, as shown above, should be used in the letter and on the envelope. If the cessation of the client-auditor relationship affects multiple SEC registrants (e.g., a parent with publicly-registered subsidiaries, series of mutual funds), the exact name of each registrant and each Commission File Number should be set forth in the SECPS letter.

SECPS Section 1000.45 Appendix K—SECPS Member Firms With Foreign Associated Firms That Audit SEC Registrants

.01 The Section acknowledges that SECPS member firms that are members of, correspondents with, or similarly associated with international firms or international associations usually do not control their international organization or individual foreign associated firms.[1] However, the Section adopted the membership requirement set forth in SECPS §1000.08(n) to obtain the assistance of SECPS member firms in their seeking to enhance the quality of SEC filings by SEC registrants[2] whose financial statements are audited by foreign associated firms. This assistance consists of SECPS member firms seeking adoption of policies and procedures by their international organizations or individual foreign associated firms that are consistent with the following objectives:

a. *Procedures for Certain Filings by SEC Registrants*—The policies and procedures should address the performance of procedures with respect to certain SEC filings by SEC registrants that are clients of foreign associated firms by a person or persons knowledgeable in accounting, auditing, and independence standards generally accepted in the U.S., independence requirements of the SEC and ISB, and SEC rules and regulations in areas where such rules and regulations are pertinent (the "filing reviewer"). The procedures are performed to provide assistance to the partner of the foreign associated firm responsible for the audit (the "audit partner-in-charge of the engagement") and the foreign associated firm. Such filings are limited to registration statements, annual reports on Form 20-F and 10-K, and other SEC filings that include or incorporate the foreign associated firm's audit report on the financial statements of an SEC registrant.

The procedures performed by the filing reviewer should generally include the following:

(1) Reading the document to be filed with the SEC with particular attention given to compliance as to form of the financial statements (and related schedules) and auditors' report with the applicable accounting and financial reporting requirements for such filings by the SEC registrant.

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[1] For this purpose, a foreign associated firm is a firm domiciled outside of the United States and its territories that is a member of, correspondent with, or similarly associated with an international firm or international association of firms with which the SECPS member is associated.

[2] See Appendix D, SECPS §1000.38, "Definition of an SEC Engagement" for purposes of determining compliance with the membership requirements of SECPS §1000.08e, f, g, h, i, k, m, n, o and p.

(2) Discussing with the audit partner-in-charge of the engagement:

(i) the engagement team's familiarity with and understanding of the applicable U.S. auditing, accounting, financial reporting, and independence standards, including independence requirements of the SEC and the ISB;

(ii) the significant differences between: (*a*) the accounting and financial reporting standards used in the presentation of the financial statements included or incorporated in the document to be filed with the SEC and those applicable in the U.S., and (*b*) the auditing and independence standards of the foreign associated firm's domicile country and those applicable in the U.S.; and

(iii) any significant auditing, accounting, financial reporting, and independence matters that come to the attention of the filing reviewer when performing the procedures described above, including how any such matters were addressed and resolved by the audit partner-in-charge of the engagement.

(3) Documenting the results of the procedures performed.

The procedures performed by the filing reviewer described above do not relieve the audit partner-in-charge of the engagement of any of the responsibilities for the performance of the audit of, and the report rendered by the foreign associated firm on, the financial statements included in the document to be filed with the SEC. Also, the filing reviewer does not assume any of the responsibilities of the audit partner-in-charge of the engagement or of any concurring reviewer.

Because of the limited nature of the procedures described above, it is recognized that the filing reviewer can not and does not assume any responsibility for detecting a departure from, or noncompliance with, accounting, auditing, and independence standards generally accepted in the U.S., independence requirements of the SEC and ISB, or SEC rules and regulations.

b. *Inspection Procedures*—The policies and procedures should address the review of a sample of audit engagements performed by foreign associated firms for clients that are SEC registrants. Such reviews may be performed as part of an annual inspection program of the international organization or the individual foreign associated firms. The reviews of engagements should be performed by a person or persons knowledgeable in accounting, auditing, and independence standards generally accepted in the U.S., independence requirements of the SEC and ISB, and SEC rules and regulations in areas where such rules and regulations are pertinent (the "inspection reviewer"). The need for knowledge of relevant specialized industry practices should be considered.

Based on the procedures performed, the inspection reviewers should determine whether anything came to their attention to cause them to believe that:

(1) the financial statements were not presented in all material respects in conformity with accounting principles generally accepted in the U.S. or, if applicable, the footnote reconciliation of the financial statements to U.S. GAAP did not include appropriate treatment of the material reconciling items,

(2) the audit engagement was not performed in accordance with auditing standards generally accepted in the U.S.,

(3) the document(s) filed with the SEC did not comply as to form of the financial statements (and related schedules) with pertinent SEC rules and regulations for such filings,

(4) the foreign associated firm did not comply with the applicable U.S. independence standards, including independence requirements of the SEC and ISB with respect to the SEC registrant, or

(5) the foreign associated firm did not comply with procedures consistent with those described in .01*a.* above.

c. Disagreements—The policies and procedures should provide that if the filing or inspection reviewer and the audit partner-in-charge of the engagement have conflicting views as to the resolution of matters that came to the attention of the filing or inspection reviewer when performing the procedures for certain filings or inspection described above, that disagreement should be resolved in accordance with the applicable policy of the international organization or of the filing or inspection reviewer's firm.

SECPS Section 1000.46 Appendix L—Independence Quality Controls

Introduction

Member firms[1] must comply with the applicable independence standards promulgated by the American Institute of Certified Public Accountants (AICPA), Independence Standards Board (ISB), and the Securities and Exchange Commission (SEC). The importance of compliance with such independence standards, and the quality control standards promulgated by the AICPA, should be reinforced by the management of the member firm, thereby setting the appropriate "tone at the top" and instilling its importance into the professional values and culture of the member firm. Member firm management should also foster an environment where the seriousness and importance of compliance can be evidenced in many forms, such as the member firm's commitment to the training of professionals on independence policies and the action taken in the case of non-compliance with such policies.

Requirements

1. Each member firm shall establish written independence policies covering relationships with "restricted entities," for example, relationships between the restricted entity and the member firm (including, where applicable, its

[1] For purposes of this requirement, *member firm*, unless otherwise noted, means the U.S. firm that is the member of the SEC Practice Section.

foreign-associated firms[2]), its benefit plans, and its professionals. These policies shall be written in language, to the extent possible, that is clear, concise, and tailored to each member firm's independence policies and procedures, given the complexity of the member firm's practice. These relationships would include investments, loans, brokerage accounts, business relationships, employment relationships, proscribed services, and fee arrangements. For purpose of this membership requirement, "restricted entities" shall include all audit clients of the member firm, and to the extent applicable its foreign-associated firms, that are SEC registrants and other entities[3] that the member firm is required to be independent of under the applicable SEC requirements.

a. Persons classified as "professional staff" (including partners) in a member firm's annual report to the SEC Practice Section (SECPS) shall be considered "professionals" for this purpose.

b. For purposes of implementing these requirements, the term "SEC registrant" is defined as (1) an issuer making an initial filing, including amendments, under the Securities Act of 1933 or the Securities Exchange Act of 1934 ("Exchange Act"); (2) a registrant that files periodic reports under the Investment Company Act of 1940 or the Exchange Act; (3) a bank or other lending institution that files periodic reports under the Exchange Act with the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, or the Office of Thrift Supervision; (4) a company whose financial statements appear in the annual report or proxy statement of an investment fund because it is a sponsor or manager of such a fund, but which is not itself a registrant required to file periodic reports under the Investment Company Act of 1940 or section 13 or 15(d) of the Exchange Act; and (5) a foreign private issuer defined by Rule 405 of Regulation C under the Securities Act of 1933 and Rule 3b-4(c) under the Exchange Act that has securities registered or has filed a registration statement with the SEC.

2. The member firm's independence policies shall be provided or otherwise made available to all professionals, as defined in paragraph 1*a*. Substantive changes to the member firm's policies shall be provided or otherwise made available on a timely basis.

3. The member firm shall establish a training program to provide reasonable assurance that professionals understand the member firm's independence policies. Each professional performing professional services for clients shall complete near the time of initial employment and periodically thereafter, independence training as required by the member firm's policies. The specific content and extent and timing of the independence training requirements shall be determined by the member firm's policies, but shall include the relevant rules regarding investments, loans, brokerage accounts, business relationships, employment relationships, proscribed services and fee arrangements.

4. Each member firm shall maintain a database ("Restricted Entity List") that includes all restricted entities, as described in paragraph 1. The member

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[2] For purposes of this requirement, a *foreign-associated firm* is an organization outside of the United States and its territories that would normally include only those organizations that are reported on the member firm's annual report to the SECPS in accordance with §1000.08(n) and Appendix K of the SECPS Reference Manual, but could include other organizations based on facts and circumstances.

[3] For practical purposes, member firms may exclude entities whose securities are not available for public sale.

firm's policies should explain why, when and how SEC registrant audit clients (and other related entities as discussed above) are to be placed on the Restricted Entity List. For member firms that provide an annual audit to more than 500 SEC registrants, an automated system to identify investment holdings of partners and managers that might impair independence is required. Member firms that provide an annual audit to more than 500 SEC registrants are required to have the automated system in place by December 31, 2000 or within a reasonable transition period upon achieving that number, not to exceed one year.

5. Each member firm shall designate a senior-level partner responsible for: (1) overseeing the adequate functioning of the independence policies of and the consultation process within the member firm; (2) providing or otherwise making the Restricted Entity List readily available to all professionals; (3) keeping the Restricted Entity List updated on at least a monthly basis; and (4) communicating additions to the Restricted Entity List on a timely basis (generally monthly).

6. Member firms that have foreign-associated firms shall provide or otherwise make available the member firm's independence policies, required in paragraph 1, and its Restricted Entity List, required in paragraph 4, to its foreign-associated firms, including the partners and managers therein. This may be accomplished directly by the member firm, by an international organization of which the member firm is a participating firm, or by a foreign-associated firm.

7. Each member firm's independence policies and procedures should specifically require the following:

a. Prior to obtaining any security or other financial interest in an entity, professionals should review the Restricted Entity List to determine whether the entity is included thereon. This review would also be required by the professional's spouse and dependents.

b. Each professional shall certify near the time of initial employment and at least annually thereafter that he or she (1) has read the member firm's independence policies, (2) understands their applicability to his or her activities and those of his or her spouse and dependents, and (3) has complied with the requirements of the member firm's independence policies since the prior certification.[4]

c. Each professional shall report apparent violations of policies involving himself or herself and his or her spouse and dependents and the corrective action taken or proposed to be taken on a timely basis when identified. Reporting apparent violations under this requirement would not include, for example, timely disposition of client securities resulting from additions to the Restricted Entity List or upon becoming subject to the independence rules of the ISB, SEC or AICPA.

d. Each member firm shall have a monitoring system under the supervision of the senior-level partner designated in 5. above to determine that adequate corrective steps are taken and documented on all apparent violations reported by professionals within the member firm. The monitoring system should include procedures to provide reasonable assurance that (i) investments of the member firm and its benefit plans are in compliance with the member firm's policies and (ii) information received from its partners and

[4] The provisions of paragraph 7*b* are effective April 1, 2000 and shall be applied prospectively.

managers is complete and accurate. The monitoring system will generally include auditing, on a sample basis, selected information such as brokerage statements, or alternative procedures that accomplish the same objective.

e. Each member firm shall develop as part of its policies, guidelines for actions to be taken against professionals for violations of independence. These policies will describe the potential sanctions to levy against those professionals for violating member firm policies and procedures or professional independence requirements.

Effective Date

Unless otherwise stated, all requirements with respect to the member firm are effective December 31, 2000. All requirements with respect to a member firm's foreign-associated firms are effective January 1, 2002.

SECPS Section 8000

Continuing Professional Education Requirements Effective for Educational Years Beginning After May 31, 2002

Basic Requirements

.01 Continuing Professional Education (CPE) is the term used by the SEC Practice Section to describe educational activities that assist a member firm's professionals (as defined in paragraph 8000.09) in achieving and maintaining quality in professional service.

This section sets forth the requirements of SEC Practice Section member firms with respect to CPE as summarized into three categories, (1) Record-keeping for each professional to ensure that each professional adheres to all CPE requirements (2) Adherence to standards for CPE program sponsors for each program sponsored by the member firm and (3) Compliance with additional CPE requirements of the SEC Practice Section.

CPE Record-keeping Requirements

.02 A member firm shall require and monitor all professionals in the member firm, regardless of whether they are AICPA members, to adhere to the following **AICPA Policies for the CPE Membership Requirement** ("**AICPA CPE Policies**", See Appendix A of Section 8000 for these detailed policies):

- **Part II Basic Requirements**
  - — **Item A—Members in Public Practice**
  - — **Item G—Documentation and Record Retention**
- **Part III Qualifying Programs**
- **Part IV Exceptions**

.03 A member firm shall require and monitor all professionals in the member firm, regardless of whether they are AICPA members, to adhere to the following **Statement on Standards for CPE Programs Issued Jointly By the AICPA and NASBA** ("**AICPA CPE Standards**", See Appendix B of Section 8000 for these detailed standards):

- **Section 100—Preamble**
- **Section 200—Standards for CPAs**

.04 All *professionals* in the member firm, regardless of whether they are AICPA members, shall be required to adhere to these AICPA CPE Policies and AICPA CPE Standards. Accordingly, for purposes of applying these rules in the SEC Practice Section, the term *member* as used in the AICPA CPE Policies and the AICPA CPE Standards, shall mean all *professionals* in the member firm.

.05 Except as provided in SECPS §8000.08(*g*), each member firm must maintain appropriate records for each professional for its most recent five

educational years. These records should contain the following information for each continuing professional education activity for which credit is claimed for the individual:

a. Sponsoring organization
b. Title of program and description of content
c. Date(s) attended or completed
d. Location of program (city/state)
e. Number of continuing professional education contact hours
f. Appropriate evidence of completion

.06 Acceptable evidence of completion includes:

a. For group programs, a certificate or other verification supplied by the sponsor
b. For a university or college course that is successfully completed for credit, a record of the grade the person received; for a non-credit course, a record of attendance and completion
c. For self-study programs, a certificate supplied by the sponsor after satisfactory completion of a workbook or examination
d. For instruction credit, evidence obtained from the sponsor of having been the instructor or discussion leader at a program
e. For published articles, books, or continuing professional education programs, evidence of publication

Requirements for Program Sponsors

.07 Each CPE program sponsored by the member firm shall adhere to the following AICPA CPE Standards, (See Appendix B of Section 8000 for these detailed standards):

- Section 300—**Standards For CPE Program Sponsors**

Additional CPE Requirements of the SEC Practice Section

.08 In addition to the requirements of §8000.02 to §8000.07 above, each SEC Practice Section member firm shall adhere to and shall require and monitor its ***professionals*** to adhere to the following:

(*a*) **Selection of an Educational Year**—Each member firm shall select any consistently applied year-long period (educational year) for applying these CPE policies. The educational year may differ from the member firm's fiscal year; however, both periods are to be specified in the annual report filed with the SECPS.[1] (See SECPS §1000.08g.) A change in a member firm's educational year shall be stated in the firm's annual report for the year in which the change is made.

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[1] When mandatory continuing professional education requirements for state licensing or for state society membership provide that the period to be used for determining compliance with those requirements shall vary by individuals (for example, the period might coincide with the date of the individual's license to practice), such periods may be used for determining whether there was compliance with the SECPS's continuing professional education requirements during the firm's educational year.

Additionally, firms with offices in more than one state that are required to employ different periods in each state for maintaining compliance with continuing professional education requirements are deemed to be in compliance with the SECPS's requirements.

(*b*) **Partial Employment Years**—Each member firm shall adhere to and monitor compliance of each of its professionals with the SEC Practice Section CPE requirements during each ***full educational year*** of the professional's employment with the firm. Except as required by other regulatory bodies referred to in paragraph 8000.08(*e*) below, these requirements do not apply to professionals during their year of hire or year of termination.[2]

(*c*) **3-Year and Annual Minimum CPE Requirements**—In accordance with the Section's membership requirement, (See §1000.08(d)), all professionals shall obtain at least 20 credits (hours) of qualifying CPE annually and at least 120 credits (hours) every three years (which includes the three most recently completed educational years through the peer review year end).

(*d*) **Accounting and Auditing CPE Requirement**—In accordance with the Section's membership requirement, (See §1000.08(d)):

a. All professionals who devote at least 25% of their time to performing audit, review or other attest engagements (excluding compilations) or

b. All professionals who have the partner / manager-level responsibility for the overall supervision or review of any such engagement

shall obtain at least 8 credits (hours) annually and 48 credits (hours) every three years of CPE in subjects related to accounting and auditing. The term *accounting and auditing subjects* should be broadly interpreted, and for example, include subjects relating to the business or economic environments of the entities to which the professional is assigned.

(*e*) **Other Regulatory Bodies**—Member firms are responsible to ensure that professionals not only meet the specific CPE requirements of the SECPS, but also meet the CPE requirements of relevant state licensing bodies and other governmental entities.

(*f*) **Grace Period**—Professionals who have not met all SEC Practice Section CPE credit (hourly) requirements in Appendix A as noted in paragraph 8000.02, paragraph 8000.03, paragraph 8000.08(*c*), and paragraph 8000.08(*d*) during either an educational year or a triennial educational period, shall have two months immediately following the period(s) to cure the deficiency. However, any hours used to make up a prior deficiency, may not also be counted towards the current period(s) requirement.

(*g*) **New SECPS Member Firms**—New member firms shall elect an educational year, which begins within twelve months of the firm joining the SECPS. New member firms will be subject to all SECPS CPE requirements effective upon the commencement of the firm's first educational year.

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[2] Member firms have a responsibility to adopt policies and procedures that provide reasonable assurance that all professional personnel are properly trained. The nature and extent of training needed by part-time personnel depend on a number of factors, including the type of work they perform, the degree of supervision they receive, and the number of hours they work. A firm should be prepared to justify any decision not to require a part-time professional to participate in the required number of continuing professional education hours.

.09 Professional Defined—Persons classified as "professional staff" (including partners) in a member firm's annual report to the SEC Practice Section (SECPS) shall be considered "professional" for purposes of these continuing professional education policies. (See SECPS §1000.08g(5)). Professionals shall include all CPA and non-CPA professionals who reside in the United States.

Appendix A—AICPA Policies for the CPE Membership Requirement

Revised December 2001

I. GENERAL

A. **Purpose**—The purpose of the continuing professional education (CPE) requirement is to increase the professional competence of each member. Members are expected to maintain the high standards of the profession by selecting quality education programs to fulfill their continuing education requirements. Members will have wide latitude in selecting continuing education programs suitable to their professional activities. This policy contains the following sections:

General	I.
Basic Requirements	II.
Qualifying Programs	III.
Exceptions	IV.
Audits of CPE	V.

B. **AICPA vs. State Requirements**—Members of the American Institute of Certified Public Accountants (AICPA) who are Certified Public Accountants licensed in specific states and/or who are members of their respective state CPA societies are cautioned that the AICPA's CPE policy, while similar in many respects to the state boards of accountancy and state CPA society policies, is not identical. For example, the AICPA's continuing education requirement covers a three-year period in contrast to the states' one- two- or three-year periods, and some states may not award CPE credit for some subjects. Thus, complying with the AICPA's policy may not necessarily maintain membership in state CPA societies or provide for continued state licensing or certification. Individuals should carefully consult the relevant state boards of accountancy and/or state CPA society guidance to ensure compliance.

C. **Effective Date**—These policies apply to all members and became effective as of January 1, 1990.

D. **Failure to Meet CPE Requirements**—Failure to meet the CPE requirements will, unless the requirement is waived under section IV, result in a loss of membership in the AICPA.

II. BASIC REQUIREMENTS

A. **Members**—From January 1, 2001, forward and for each three-year reporting period thereafter, all AICPA members shall complete 120 hours, or its equivalent, of continuing professional education. Compliance can be achieved either by a formal program of education or by any other means, however measured, that would be reasonably expected to maintain professional competencies in the member's area of practice or employment. Members shall report compliance with such requirement to the AICPA each year and shall keep appropriate records and submit copies of such on request of the Institute.

B. **New Members**—For those individuals joining the AICPA on January 1, 1990, and thereafter ("new members"), the three-year reporting period and the CPE requirements begin in the calendar year following the year membership commences. For example, a new member in calendar year 1993 begins a three-year reporting period on January 1, 1994, which ends December 31, 1996, and is required, beginning for the calendar year 1994, to comply with the CPE requirements set forth above.

C. **Reinstatement**—Individuals applying for reinstatement who have voluntarily or involuntarily lost their membership or come out of retirement or inactive status shall be treated as "new members." Their new three-year reporting period for CPE requirements begins in the calendar year following their reinstatement.

D. **Changing Status**—Members changing from or to public practice do not begin a new three-year reporting period. However, the CPE requirement shall be adjusted to the following three-year totals:

	Year of Change		
	Year 1	*Year 2*	*Year 3*
To Public Practice	120	110	100
From Public Practice	100	110	120

E. **Grace Period**—Any member who has not completed the required number of hours during a reporting period will be allowed the two months immediately following the period to make up the deficiency. Hours credited toward a deficiency during this two-month period may not be counted toward the annual minimum requirement of the educational year in which they are taken. Furthermore, any continuing professional education hours claimed during the two-month period to make up any deficiency for the preceding three-year period may not be counted toward the requirement for the three-year reporting period in which they are taken.

F. **Reporting**—No separate reporting is required. By paying their dues each year, members affirm they are in compliance with the CPE membership requirements. Members should keep detailed records of the CPE they complete in the event they are selected to verify their compliance. See the next section for information that should be retained.

G. **Documentation and Records Retention**—Members of the AICPA bear the primary responsibility of documenting that they have complied with the CPE requirements. They should retain evidence of satisfactory completion for a period of five years after the completion of the educational programs. For each CPE program completed, members should be able to document the following:

1. Sponsor
2. Title and description of content
3. Date(s)
4. Location
5. Number of CPE contact hours.

III. QUALIFYING PROGRAMS

Members have wide latitude in selecting continuing professional education suitable to their professional activities. The underlying principle is that all programs should contribute to a member's professional competence. Acceptable subjects include the fields of study set forth in the AICPA National CPE Curriculum: accounting and auditing, consulting services, specialized knowledge and applications, management, personal development, and taxation. Other subjects may also be acceptable if they maintain and/or increase the accounting professional's competence. Members have the option of selecting programs that relate to their specific jobs. For example, a member in industry who is engaged in marketing activities may fulfill the requirement by completing continuing education in marketing and a member who owns or operates a small business may complete CPE that relates to running that business.

Members may participate in CPE programs sponsored by a wide variety of organizations including, but not limited to, the AICPA, state societies of CPAs, other professional associations, colleges and universities, and their own firms. Service as an instructor at a CPE program may qualify when it increases the instructor's professional competence. Writing published articles, books or CPE programs may also qualify.

CPE credit should be measured in whole hours and claimed only for the time a group study program is actually attended. (CPE credit is measured in 50-minute "contact hours.") CPE credit for self-study programs is recommended by the sponsor and must be documented by a certificate or other evidence of completion.

Ultimately the CPE credit claimed is the responsibility of the individual member. Each member must only claim credit for the formal programs of learning he or she actually completed that contributed to his or her professional competence.

For more detailed information about qualifying programs, please refer to the *Statement on Standards for Continuing Professional Education (CPE) Programs* which is included here [sections 100–400] as part of these policies. Members must comply with those standards that apply to individual accounting professionals—namely, the standards in these sections: General Standards, Standards for CPE Program Measurement, and Standards for CPE Program Reporting. The other two sections contain standards that apply to program developers and program sponsors. To the extent a member is in the role of a program developer or sponsor, he or she must also comply with the developer and sponsor standards. Members are not responsible to see that the program developers and sponsors of programs they attend are in compliance with the CPE standards.

IV. EXCEPTIONS

A. **General**—Members may request a waiver if they are prohibited from fulfilling the CPE requirements for the reasons set forth below. Such requests must be submitted in writing to the CPE Division of the AICPA. When the status changes from the one for which the exception applies, the CPE requirement begins in the calendar year following the change.

   1. **Foreign Residency**—The request should include the country of residence, the name of the employer, the principal duties and responsibilities performed, and the reasons foreign residency prohibits fulfilling the requirement.

2. **Health**—The request should include the nature of the illness, the name and address of the attending physician, and the reason the illness prohibits fulfilling the requirement.
3. **Military Service**—The request should include the principal duties performed, where stationed, the name and address of member's commanding officer, and the reason why military service prohibits fulfilling the requirement.
4. **Other Similar Reasons**—The request should include the nature of the hardship and the reason why it prohibits fulfilling the CPE requirement.

B. **Retired and Inactive Members**—For purposes of the CPE requirement, "retired" and "inactive" mean a member is in one of those categories for paying AICPA dues. Retired members and inactive members who are unemployed or have left the workforce to raise a family are exempt from the CPE requirement. Members who are retired or exempt for any part of the year are exempt for the full year.

V. AUDITS OF CPE

The AICPA will verify compliance on a test basis. The extent and scope of such examination will be determined and administered by the AICPA.

Appendix B—AICPA Statement on Standards For Continuing Professional Education Programs

The following standards are issued jointly by the AICPA and NASBA.

Section 100—Preamble

01. The right to use the title "Certified Public Accountant" (CPA) is regulated in the public interest and imposes a duty to maintain public confidence and current knowledge, skills, and abilities in all areas in which they provide services. CPAs must accept and fulfill their ethical responsibilities to the public and the profession regardless of their fields of employment.[3]

02. The profession of accountancy is characterized by an explosion of relevant knowledge, ongoing changes and expansion, and increasing complexity. Advancing technology, globalization of commerce, increasing specialization, proliferating regulations, and the complex nature of business transactions have created a dynamic environment that requires CPAs to continuously maintain and enhance their knowledge, skills, and abilities.

03. The continuing development of professional competence involves a program of lifelong educational activities. Continuing Professional Education (CPE) is the term used in these standards to describe the educational activities that assist CPAs in achieving and maintaining quality in professional services.

04. The following standards have been broadly stated in recognition of the diversity of practice and experience among CPAs. They establish a framework for the development, presentation, measurement, and reporting of CPE programs and thereby help to ensure that CPAs receive the quality CPE necessary to satisfy their obligations to serve the public interest.

Section 200—Standards for CPAs

General Standards

01. Standard No. 1. All CPAs should participate in learning activities that maintain and/or improve their professional competence.[4]

02. Commentary. Selection of learning activities should be a thoughtful, reflective process addressing the individual CPA's current and future professional plans, current knowledge and skills level, and desired or needed additional competence to meet future opportunities and/or professional responsibilities.

03. CPAs' fields of employment do not limit the need for CPE. CPAs performing professional services need to have a broad range of knowledge, skills, and abilities. Thus, the concept of professional competence should be interpreted broadly. Accordingly, acceptable continuing education encompasses

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[3] The term "CPAs" is used in these standards to identify all persons who are licensed and/or regulated by boards of accountancy.

[4] The terms "should" and "must" are intended to convey specific meanings within the context of this *Joint AICPA/NASBA Statement on Standards for Continuing Professional Education Programs* [sections 100–400]. The term "must" is used only in the standards applying to CPE program sponsors to convey that CPE program sponsors are not permitted any departure from those specific standards. The term "should" is used in the standards applying to both CPAs and CPE program sponsors and is intended to convey that CPAs and CPE program sponsors are expected to follow such standards as written and are required to justify any departures from such standards when unusual circumstances warrant such departures.

programs contributing to the development and maintenance of both technical and non-technical professional skills.

04. Acceptable subjects include accounting, assurance/auditing, consulting services, specialized knowledge and applications, management, taxation, and ethics. Other subjects, including personal development, may also be acceptable if they maintain and/or improve the CPA's professional competence.

05. To help guide their professional development, CPAs may find it useful to develop a learning plan (see definition in Glossary [section 400.15]). The learning plan can be used to evaluate learning and professional competence development. It should be reviewed periodically and modified as professional competence needs change.

06. Standard No. 2. CPAs should comply with all applicable CPE requirements and should claim CPE credit only for CPE programs when the CPE program sponsors have complied with the Standards for CPE Program Presentation (Nos. 8–11) and Standard for CPE Program Reporting No. 17.

07. Commentary. CPAs are responsible for compliance with all applicable CPE requirements, rules, and regulations of state licensing bodies, other governmental entities, membership associations, and other professional organizations or bodies. CPAs should contact each appropriate entity to which they report to determine its specific requirements or any exceptions it may have to the standards presented herein.

08. Periodically, CPAs participate in learning activities which do not comply with all applicable CPE requirements, for example specialized industry programs offered through industry sponsors. If CPAs propose to claim credit for such learning activities, they should retain all relevant information regarding the program to provide documentation to state licensing bodies and/or all other professional organizations or bodies that the learning activity is equivalent to one which meets all these Standards.

09. Standard No. 3. CPAs are responsible for accurate reporting of the appropriate number of CPE credits earned and should retain appropriate documentation of their participation in learning activities, including: (1) name and contact information of CPE program sponsor, (2) title and description of content, (3) date(s) of program, (4) location (if applicable), and (5) number of CPE credits, all of which should be included in documentation provided by the CPE program sponsor.

10. Commentary. To protect the public interest, regulators require CPAs to document maintenance and enhancement of professional competence through periodic reporting of CPE. For convenience, measurement is expressed in CPE credits. However, the objective of CPE must always be maintenance/enhancement of professional competence, not attainment of credits. Compliance with regulatory and other requirements mandates that CPAs keep documentation of their participation in activities designed to maintain and/or improve professional competence. In the absence of legal or other requirements, a reasonable policy is to retain documentation for a minimum of five years from the end of the year in which the learning activities were completed.

11. Participants must document their claims of CPE credit. Examples of acceptable evidence of completion include:

- For group and independent study programs, a certificate or other verification supplied by the CPE program sponsor.
- For self-study programs, a certificate supplied by the CPE program sponsor after satisfactory completion of an examination.

- For instruction credit, a certificate or other verification supplied by the CPE program sponsor.
- For a university or college course that is successfully completed for credit, a record or transcript of the grade the participant received.
- For university or college non-credit courses, a certificate of attendance issued by a representative of the university or college.
- For published articles, books, or CPE programs, (1) a copy of the publication (or in the case of a CPE program, course development documentation) that names the writer as author or contributor, (2) a statement from the writer supporting the number of CPE hours claimed, and (3) the name and contact information of the independent reviewer(s) or publisher.

12. Standard No. 4. CPAs who complete sponsored learning activities that maintain or improve their professional competence should claim the CPE credits recommended by CPE program sponsors.

13. Commentary. CPAs may participate in a variety of sponsored learning activities, such as workshops, seminars and conferences, self-study courses, Internet-based programs, and independent study. While CPE program sponsors determine credits, CPAs should claim credit only for activities through which they maintained or improved their professional competence. CPAs who participate in only part of a program should claim CPE credit only for the portion they attended or completed.

14. Standard No. 5. CPAs may engage in independent study under the direction of a CPE program sponsor who has met the applicable standards for CPE program sponsors when the subject matter and level of study maintain or improve their professional competence.

15. Commentary. Independent study is an educational process designed to permit a participant to learn a given subject under the guidance of a CPE program sponsor one-on-one. Participants in an independent study program should:

- Enter into a written learning contract with a CPE program sponsor who must comply with the applicable standards for CPE program sponsors.
- Accept the written recommendation of the CPE program sponsor as to the number of credits to be earned upon successful completion of the proposed learning activities. CPE credits will be awarded only if:
    1. All the requirements of the independent study as outlined in the learning contract are met,
    2. The CPE program sponsor reviews and signs the participant's report,
    3. The CPE program sponsor reports to the participant the actual credits earned, and
    4. The CPE program sponsor provides the participant with contact information.

    The credits to be recommended by an independent study CPE program sponsor should be agreed upon in advance and should be equated to the effort expended to improve professional competence. The credits cannot exceed the time devoted to the learning activities and may be less than the actual time involved.

- Retain the necessary documentation to satisfy regulatory requirements as to the content, inputs, and outcomes of the independent study.
- Complete the program of independent study in 15 weeks or less.

Section 300—Standards for CPE Program Sponsors

General Standards

01. Standard No. 1. CPE program sponsors are responsible for compliance with all applicable standards and other CPE requirements.

02. Commentary. CPE program sponsors may have to meet specific CPE requirements of state licensing bodies, other governmental entities, membership associations, and/or other professional organizations or bodies. Professional guidance for CPE program sponsors is available from the AICPA and NASBA; state-specific guidance is available from the state boards of accountancy. CPE program sponsors should contact the appropriate entity to determine requirements.

Standards for CPE Program Development

03. Standard No. 2. Sponsored learning activities must be based on relevant learning objectives and outcomes that clearly articulate the knowledge, skills, and abilities that can be achieved by participants in the learning activities.

04. Commentary. Learning activities provided by CPE program sponsors for the benefit of CPAs should specify the level, content, and learning objectives so that potential participants can determine if the learning activities are appropriate to their professional competence development needs. Levels include, for example, basic, intermediate, advanced, update, and overview (see definitions in Glossary [section 400]).

05. Standard No. 3. CPE program sponsors should develop and execute learning activities in a manner consistent with the prerequisite education, experience, and/or advance preparation of participants.

06. Commentary. To the extent it is possible to do so, CPE program sponsors should make every attempt to equate program content and level with the backgrounds of intended participants. All programs must clearly identify prerequisite education, experience, and/or advance preparation, if any, in precise language so that potential participants can readily ascertain whether they qualify for the program.

07. Standard No. 4. CPE program sponsors must use activities, materials, and delivery systems that are current, technically accurate, and effectively designed. CPE program sponsors must be qualified in the subject matter.

08. Commentary. To best facilitate the learning process, sponsored programs and materials must be prepared, presented and updated timely. Learning activities must be developed by individuals or teams having expertise in the subject matter. Expertise may be demonstrated through practical experience or education.

09. CPE program sponsors must review the course materials periodically to assure that they are accurate and consistent with currently accepted standards relating to the program's subject matter.

10. Standard No. 5. CPE program sponsors of group and self-study programs must ensure learning activities are reviewed by qualified persons other than those who developed them to assure that the program is technically accurate and current and addresses the stated learning objectives. These reviews must occur before the first presentation of these materials and again after each significant revision of the CPE programs.

11. Commentary. Individuals or teams qualified in the subject matter must review programs. When it is impractical to review certain programs in advance, such as lectures given only once, greater reliance should be placed on the recognized professional competence of the instructors or presenters. Using independent reviewing organizations familiar with these standards may enhance quality assurance.

12. Standard No. 6. CPE program sponsors of independent study learning activities must be qualified in the subject matter.

13. Commentary. A CPE program sponsor of independent study learning activities must have expertise in the specific subject area related to the independent study. The CPE program sponsor must also:

- Review, evaluate, approve and sign the proposed independent study learning contract, including agreeing in advance on the number of credits to be recommended upon successful completion.
- Review and sign the written report developed by the participant in independent study.
- Retain the necessary documentation to satisfy regulatory requirements as to the content, inputs, and outcomes of the independent study.

14. Standard No. 7. Self-study programs must employ learning methodologies that clearly define learning objectives, guide the participant through the learning process, and provide evidence of a participant's satisfactory completion of the program.

15. Commentary. To guide participants through a learning process, CPE program sponsors of self-study programs must elicit participant responses to test for understanding of the material, offer evaluative feedback to incorrect responses, and provide reinforcement feedback to correct responses. To provide evidence of satisfactory completion of the course, CPE program sponsors of self-study programs must require participants to successfully complete a final examination with a minimum-passing grade of at least 70 percent before issuing CPE credit for the course. Examinations may contain questions of varying format, (for example, multiple-choice, essay and simulations.) If objective type questions are used, at least five questions per CPE credit must be included on the final examination. For example, the final examination for a five-credit course must include at least 25 questions.

16. Self-study programs must be based on materials specifically developed for instructional use. Self-study programs requiring only the reading of general professional literature, IRS publications, or reference manuals followed by a test will not be acceptable. However, the use of the publications and reference materials in self-study programs as supplements to the instructional materials could qualify if the self-study program complies with each of the CPE standards.

Standards for CPE Program Presentation

17. Standard No. 8. CPE program sponsors must provide descriptive materials that enable CPAs to assess the appropriateness of learning activities. To accomplish this, CPE program sponsors must inform participants in advance of:

- **Learning objectives.**
- **Prerequisites.**
- **Program level.**
- **Program content.**
- **Advance preparation.**
- **Instructional delivery methods.**
- **Recommended CPE credit.**
- **Course registration requirements.**

18. Commentary. For potential participants to effectively plan their CPE, the program sponsor should disclose the significant features of the program in advance (e.g., through the use of brochures, Internet notices, invitations, direct mail, or other announcements). When CPE programs are offered in conjunction with noneducational activities, or when several CPE programs are offered concurrently, participants should receive an appropriate schedule of events indicating those components that are recommended for CPE credit. The CPE program sponsor's registration policies and procedures should be formalized, published, and made available to participants.

19. CPE program sponsors should distribute program materials timely and encourage participants to complete any advance preparation requirements. All programs should clearly identify prerequisite education, experience, and/or advance preparation requirements, if any, in the descriptive materials. Prerequisites should be written in precise language so that potential participants can readily ascertain whether they qualify for the program.

20. Standard No. 9. CPE program sponsors must ensure instructors are qualified with respect to both program content and instructional methods used.

21. Commentary. Instructors are key ingredients in the learning process for any group program. Therefore, it is imperative that CPE program sponsors exercise great care in selecting qualified instructors for all group programs. Qualified instructors are those who are capable, through training, education, or experience of communicating effectively and providing an environment conducive to learning. They should be competent and current in the subject matter, skilled in the use of the appropriate instructional methods and technology, and prepared in advance.

22. CPE program sponsors should evaluate the instructor's performance at the conclusion of each program to determine the instructor's suitability to serve in the future.

23. Standard No. 10. CPE program sponsors must employ an effective means for evaluating learning activity quality with respect to content and presentation, as well as provide a mechanism for participants to assess whether learning objectives were met.

24. Commentary. The objectives of evaluation are to assess participant satisfaction with specific programs and to increase subsequent program effectiveness. Evaluations, whether written or electronic, should be solicited from

participants and instructors for each program session, including self-study, to determine, among other things, whether:

- Stated learning objectives were met.
- If applicable, prerequisite requirements were appropriate.
- Program materials were accurate.
- Program materials were relevant and contributed to the achievement of the learning objectives.
- Time allotted to the learning activity was appropriate.
- If applicable, individual instructors were effective.
- Facilities and/or technological equipment was appropriate.
- Handout or advance preparation materials were satisfactory.
- Audio and video materials were effective.

25. CPE program sponsors should periodically review evaluation results to assess program effectiveness and should inform developers and instructors of evaluation results.

26. Standard No. 11. CPE program sponsors must ensure instructional methods employed are appropriate for the learning activities. Learning activities should be presented in a manner consistent with the descriptive and technical materials provided.

27. Commentary. CPE program sponsors should evaluate the instructional methods employed for the learning activities to determine if the delivery is appropriate and effective. Integral aspects in the learning environment that should be carefully monitored include the number of participants and the facilities and technologies employed in the delivery of the learning activity.

28. CPE program sponsors are expected to present learning activities that comply with course descriptions and objectives. Appropriate supplemental materials may also be used.

Standards for CPE Program Measurement

29. Standard No. 12. Sponsored learning activities are measured by program length, with one 50-minute period equal to one CPE credit. One-half CPE credit increments (equal to 25 minutes) are permitted after the first credit has been earned in a given learning activity.

30. Commentary. For learning activities in which individual segments are less than 50 minutes, the sum of the segments should be considered one total program. For example, five 30-minute presentations would equal 150 minutes and should be counted as three CPE credits. When the total minutes of a sponsored learning activity are greater than 50, but not equally divisible by 50, the CPE credits granted should be rounded down to the nearest one-half credit. Thus, learning activities with segments totaling 140 minutes should be granted two and one-half CPE credits.

31. While it is the participant's responsibility to report the appropriate number of credits earned, CPE program sponsors must monitor group learning activities to assign the correct number of CPE credits.

32. For university or college credit courses that meet these CPE Standards, each unit of college credit shall equal the following CPE credits:

- Semester System 15 credits
- Quarter System 10 credits

33. For university or college non-credit courses that meet these CPE standards, CPE credits shall be awarded only for the actual classroom time spent in the non-credit course.

34. Credit is not granted to participants for preparation time.

35. Only the portions of committee or staff meetings that are designed as programs of learning and comply with these standards qualify for CPE credit.

36. Standard No. 13. CPE credit for self-study learning activities must be based on a pilot test of the average completion time.

37. Commentary. A sample of intended professional participants should be selected to test program materials in an environment and manner similar to that in which the program is to be presented. The sample group of at least three individuals must be independent of the program development group and possess the appropriate level of knowledge before taking the program. The sample does not have to ensure statistical validity. CPE credits should be recommended based on the average completion time for the sample. If substantive changes are subsequently made to program materials further pilot tests of the revised program materials should be conducted to affirm or amend, as appropriate, the average completion time.

38. Standard No. 14. Instructors or discussion leaders of learning activities should receive CPE credit for both their preparation and presentation time to the extent the activities maintain or improve their professional competence and meet the requirements of these CPE standards.

39. Commentary. Instructors, discussion leaders, or speakers who present a learning activity for the first time should receive CPE credit for actual preparation time up to two times the number of CPE credits to which participants would be entitled, in addition to the time for presentation. For example, for learning activities in which participants could receive 8 CPE credits, instructors may receive up to 24 CPE credits (16 for preparation plus 8 for presentation). For repeat presentations, CPE credit can be claimed only if it can be demonstrated that the learning activity content was substantially changed and such change required significant additional study or research.

40. Standard No. 15. Writers of published articles, books, or CPE programs should receive CPE credit for their research and writing time to the extent it maintains or improves their professional competence.

41. Commentary. Writing articles, books, or CPE programs for publication is a structured activity that involves a process of learning. For the writer to receive CPE credit, the article, book, or CPE program must be formally reviewed by an independent party. CPE credits should be claimed only upon publication.

42. Standard No. 16. CPE credits recommended by a CPE program sponsor of independent study must not exceed the time the participant devoted to complete the learning activities specified in the learning contract.

43. Commentary. The credits to be recommended by an independent study CPE program sponsor should be agreed upon in advance and should be equated to the effort expended to improve professional competence. The credits cannot exceed the time devoted to the learning activities and may be less than the actual time involved.

Standards for CPE Program Reporting

44. Standard No. 17. CPE program sponsors must provide program participants with documentation of their participation, which includes the following:

- **CPE program sponsor name and contact information.**
- **Participant's name.**
- **Course title.**
- **Course field of study.**
- **Date offered or completed.**
- **If applicable, location.**
- **Type of instructional/delivery method used.**
- **Amount of CPE credit recommended.**
- **Verification by CPE program sponsor representative.**

45. Commentary. CPE program sponsors should provide participants with documentation to support their claims of CPE credit. Acceptable evidence of completion includes:

- For group and independent study programs, a certificate or other verification supplied by the CPE program sponsor.
- For self-study programs, a certificate supplied by the CPE program sponsor after satisfactory completion of an examination.
- For instruction credit, a certificate or other verification supplied by the CPE program sponsor.
- For a university or college course that is successfully completed for credit, a record or transcript of the grade the participant received.
- For university or college non-credit courses, a certificate of attendance issued by a representative of the university or college.
- For published articles, books, or CPE programs, (1) a copy of the publication (or in the case of a CPE program, course development documentation) that names the writer as author or contributor, (2) a statement from the writer supporting the number of CPE hours claimed, and (3) the name and contact information of the independent reviewer(s) or publisher.

46. Standard No. 18. CPE program sponsors must retain adequate documentation for five years to support their compliance with these standards and the reports that may be required of participants.

47. Commentary. Evidence of compliance with responsibilities set forth under these Standards which is to be retained by CPE program sponsors includes, but is not limited to:

- Records of participation.
- Dates and locations.
- Instructor names and credentials.
- Number of CPE credits earned by participants.
- Results of program evaluations.

Information to be retained by developers includes copies of program materials, evidence that the program materials were developed and reviewed by qualified parties, and a record of how CPE credits were determined.

48. For CPE program sponsors offering self-study programs, appropriate pilot test records must be retained regarding the following:

- When the pilot test was conducted.
- The intended participant population.
- How the sample was determined.
- Names and profiles of sample participants.
- A summary of participants' actual completion time.

Section 400—Glossary

01. Advanced. Learning activity level most useful for individuals with mastery of the particular topic. This level focuses on the development of in-depth knowledge, a variety of skills, or a broader range of applications.

Advanced level programs are often appropriate for seasoned professionals within organizations; however, they may also be beneficial for other professionals with specialized knowledge in a subject area.

02. Basic. Learning activity level most beneficial to CPAs new to a skill or an attribute. These individuals are often at the staff or entry level in organizations, although such programs may also benefit a seasoned professional with limited exposure to the area.

03. Continuing Professional Education (CPE). An integral part of the lifelong learning required to provide competent service to the public. The set of activities that enables CPAs to maintain and improve their professional competence.

04. CPE credit. Fifty minutes of participation in a group, independent study or self-study program. One-half CPE credit increments (equal to 25 minutes) are permitted after the first credit has been earned in a given learning activity.

05. CPE program sponsor. The individual or organization responsible for setting learning objectives, developing the program materials to achieve such objectives, offering a program to participants, and maintaining the documentation required by these standards. The term CPE program sponsor may include associations of CPAs, whether formal or informal, as well as employers who offer in-house programs.

06. Evaluative feedback. Specific response to incorrect answers to questions in self-study programs. Unique feedback must be provided for each incorrect response, as each one is likely to be wrong for differing reasons.

07. Group program. An educational process designed to permit a participant to learn a given subject through interaction with an instructor and other participants either in a classroom or conference setting or by using the Internet.

08. Independent study. An educational process designed to permit a participant to learn a given subject under a learning contract with a CPE program sponsor.

09. Instructional methods. Delivery strategies such as case studies, computer-assisted learning, lectures, group participation, programmed

instruction, teleconferencing, use of audiovisual aids, or work groups employed in group, self-study, or independent study programs.

10. Intermediate. Learning activity level that builds on a basic program, most appropriate for CPAs with detailed knowledge in an area. Such persons are often at a mid-level within the organization, with operational and/or supervisory responsibilities.

11. Internet-based programs. A learning activity, through a group program (paragraph .07 above) or a self-study program (paragraph .22 following), that is designed to permit a participant to learn the given subject matter via the Internet. To qualify as either a group or self-study program, the Internet learning activity must meet the respective standards.

12. Learning activity. An educational endeavor that maintains or improves professional competence.

13. Learning contract. A written contract signed by an independent study participant and a qualified CPE program sponsor prior to the commencement of the independent study that:

1. Specifies the nature of the independent study program and the time frame over which it is to be completed, not to exceed 15 weeks.
2. Specifies that the output must be in the form of a written report that will be reviewed by the CPE program sponsor or a qualified person selected by the CPE program sponsor.
3. Outlines the maximum CPE credit that will be awarded for the independent study program, but limits credit to actual time spent.

14. Learning objectives. Specifications on what participants should accomplish in a learning activity. Learning objectives are useful to program developers in deciding appropriate instructional methods and allocating time to various subjects.

15. Learning plans. Structured processes that help CPAs guide their professional development. They are dynamic instruments used to evaluate and document learning and professional competence development. This may be reviewed regularly and modified, as CPAs' professional competence needs change. Plans include:

- A self-assessment of the gap between current and needed knowledge, skills, and abilities;
- A set of learning objectives arising from this assessment; and
- Learning activities to be undertaken to fulfill the learning plan.

16. Overview. Learning activity level that provides a general review of a subject area from a broad perspective. These programs may be appropriate for professionals at all organizational levels.

17. Personal development. A field of study that covers such skills as communications, managing the group process, dealing effectively with others, interviewing, counseling, and career planning.

18. Pilot test. Sampling of at least three independent individuals representative of the intended participants to measure the average completion time to determine the recommended CPE credit for self-study programs.

19. Professional competence. Having requisite knowledge, skills, and abilities to provide quality services as defined by the technical and ethical standards of the profession. The expertise needed to undertake professional responsibilities and to serve the public interest.

20. Program of learning. A collection of learning activities that are designed and intended as continuing education and that comply with these standards.

21. Reinforcement feedback. Specific responses to correct answers to questions in self-study programs. Such feedback restates why the answer selected was correct.

22. Self-study program. An educational process designed to permit a participant to learn a given subject without major involvement of an instructor. Self-study programs use a pilot test to measure the average completion time from which the recommended CPE credit is determined.

23. Update. Learning activity level that provides a general review of new developments. This level is for participants with a background in the subject area who desire to keep current.

Effective Dates:

Unless otherwise established by state licensing bodies and/or other professional organizations, these Standards are to be effective as follows:

- For CPAs, group programs and independent study—January 1, 2002.
- For self-study courses being published for the first time after December 31, 2002—upon publication.
- For self-study courses already in existence as of December 31, 2002—January 1, 2004.

PCAOB Staff Guidance

PCAOB STAFF GUIDANCE

TABLE OF CONTENTS

Section 100

SELECT PCAOB STAFF QUESTIONS AND ANSWERS

.01 STAFF QUESTIONS AND ANSWERS

Audits of Financial Statements of Non-Issuers Performed Pursuant to the Standards of the Public Company Accounting Oversight Board

June 30, 2004

Summary

Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff questions and answers related to PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* ("Auditing Standard No. 1"), were prepared by the Office of the Chief Auditor. Questions should be directed to C. Gregory Scates, Associate Chief Auditor (202/207-9114; scatesg@pcaobus.org), or Thomas Ray, Deputy Chief Auditor (202/207-9112; rayt@pcaobus.org).

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The Sarbanes-Oxley Act of 2002 (the "Act") directs the Public Company Accounting Oversight Board to establish auditing and related attestation, quality control, ethics and independence standards, to be used by registered public accounting firms in the preparation and issuance of audit reports of issuers.[1] The Act and PCAOB Rules require audits of issuers to be conducted in accordance with PCAOB standards. When issuing an audit report on the financial statements of an issuer, PCAOB Auditing Standard No. 1 requires registered public accounting firms to include a reference to "the standards of the Public Company Accounting Oversight Board (United States)." In contexts other than an audit of the financial statements of an issuer, however, auditors, whether registered or not, may be legally required to, or may agree voluntarily to, perform an engagement in accordance with PCAOB standards or some portion of

[1] Section 2(a) of the Act defines "issuer" as "an issuer (as defined in Section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under Section 12 of the Act (15 U.S.C. 781), or that is required to file reports under Section 15(d)(15 U.S.C. 780(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn."

those standards.[2] Auditors and other interested persons have raised questions about the implications of Auditing Standard No. 1, as well as the Act and other PCAOB rules, for such engagements. The following staff questions and answers seek to answer some of those questions.

Q1. Must a public accounting firm be registered with the PCAOB to perform an audit of a non-issuer according to PCAOB standards?

A1. No. The Sarbanes-Oxley Act requires only that those public accounting firms that prepare or issue, or participate in the preparation or issuance of, audit reports on the financial statements of issuers be registered.[3]

Q2. The PCAOB's Auditing Standard No. 1 requires the auditor to include a reference to "the standards of the Public Company Accounting Oversight Board (United States)" in audit reports on the financial statements of issuers. May an auditor refer to "the auditing standards of the Public Company Accounting Oversight Board (United States)" rather than to "the standards of the Public Company Accounting Oversight Board (United States)" in an audit report on an audit of the financial statements of a non-issuer that was performed in accordance with the Board's auditing standards?

A2. Yes. In an audit of the financial statements of a non-issuer, an auditor may wish to be clear that he or she adhered to only the auditing standards of the PCAOB; accordingly, the auditor may include the word " auditing" in the reference to the standards of the PCAOB. Registered public accounting firms, however, are not permitted to limit their reference to the "auditing standards " of the PCAOB in their audit reports on the financial statements of issuers.

Q3. What standards are included in a reference to "the standards of the Public Company Accounting Oversight Board (United States)"?

A3. A reference to "the standards of the Public Company Accounting Oversight Board (United States)" includes the standards of the Board that are applicable in the circumstances of the engagement. For example, in an audit of financial statements that does not involve the use of a specialist, the auditor would not be expected to follow the Board's interim auditing standard, Statement of Auditing Standards No. 73, "Using the Work of a Specialist." Similarly, in an audit of an entity that has immaterial inventory balances, the auditor would not be expected to follow the Board's interim auditing standard, AU Section 331, "Inventories," of Statement on Auditing Standards No. 1, "Codification of Auditing Standards and Procedures." On the other hand, the Board's interim auditing standard, Statement on Auditing Standards No. 99, "Consideration of Fraud in a Financial Statement Audit," would be applicable in all audits of financial statements conducted pursuant to the Board's standards. As another example, quality control standards generally apply to a firm's system of quality control over its accounting and auditing practice and not to individual audit engagements. Thus, a breakdown in the system of quality control does not necessarily mean that a particular audit was not conducted in accordance with the standards of the PCAOB. However, such a breakdown might result in a deficient audit if it caused or contributed to an audit deficiency. In addition, an auditor who states that he or she has performed the audit in accordance with

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[2] See, e.g., Securities Exchange Act of 1934 Rule 17i-6(d), 17 CFR 240.17i-6(d) (requiring supervised investment bank holding companies to obtain an audit and review "in accordance with the rules promulgated by the Public Company Accounting Oversight Board").

[3] The SEC has ordered that broker-dealers that are not issuers need not file with the Commission, and send to their customers, financial statements certified by a registered public accounting firm until January 1, 2005, unless rules are in place regarding Board registration of auditors of such broker-dealers that set an earlier date. See Notice, Broker-Dealer Financial Statement Requirements under Section 17 of the Exchange Act, Rel. No. 34-48281 (August 4, 2003).

the standards of the PCAOB must be in compliance with the applicable interim independence standards of the Board. These are examples only, and not an exhaustive list of standards that may be applicable to an engagement. While not required by PCAOB rules, auditors of issuers and other entities subject to the SEC's jurisdiction are reminded that they must also comply with applicable Commission requirements, including the Commission's auditor independence requirements.

Q4. By referring to "the auditing standards of the Public Company Accounting Oversight Board (United States)" in an audit report on the financial statements of a non-issuer, does the auditor represent that he or she has adhered to the Board's interim independence standards?

A4. No. Auditors of the financial statements of non-issuers, including nonprofit organizations, government agencies, municipalities and other governments, should look to relevant state and federal laws and regulations relating to auditor independence. Auditors of nonpublic companies should bear in mind, however, that any company that becomes an issuer, as defined in Section 2(a)(7) of the Act, must file with the SEC an audit report prepared and issued by an independent registered public accounting firm, and therefore it may behoove an auditor of a nonpublic company that intends to become an issuer to comply with SEC and PCAOB independence requirements.

Q5. By referring to "the auditing standards of the Public Company Accounting Oversight Board (United States)" or to "the standards of the Public Company Accounting Oversight Board (United States)" in an audit report on the financial statements of a non-issuer, does the auditor represent that he or she has complied with the Commission's auditor independence requirements?

A5. No. A Note to the PCAOB's rule on interim independence standards, PCAOB Rule 3600T, reminds auditors of issuers and other entities subject to the SEC's jurisdiction of their separate obligations under the SEC's rule on auditor independence. The PCAOB's rule on interim independence standards does not, however, incorporate the SEC's auditor independence requirements.

Q6. What are the PCAOB's independence requirements and to whom do they apply?

A6. The PCAOB adopted interim independence standards when it adopted PCAOB Rule 3600T, which is a temporary rule in effect until the Board adopts permanent independence standards. Rule 3600T requires that, when a registered public accounting firm conducts an audit of the financial statements of an issuer, the firm comply with—

- Rule 101 of the AICPA's Code of Professional Conduct, and interpretations and rulings thereunder, as in existence on April 16, 2003; and
- Standards Nos. 1, 2 and 3, and Interpretations 99-1, 00-1, and 002, of the Independence Standards Board.

Registered public accounting firms must also comply with SEC requirements, including its Rule 2-01 of Regulation S-X, relating to auditor independence, when they conduct audits required by the federal securities laws, including audits of financial statements of issuers. The Board did not adopt the SEC's Rule 2-01 because that rule already governs auditor independence from issuers. As a Note to Rule 3600T makes clear, however, in an audit of the financial statements of an issuer, to the extent that a provision of the SEC's rule is more restrictive—or less restrictive—than the Board's interim independence standards, a registered public accounting firm must comply with the more restrictive rule.

Q7. Does a reference to "the auditing standards of the Public Company Accounting Oversight Board (United States)" or to "the standards of the Public Company Accounting Oversight Board (United States)" in an auditor's report on the financial statements of a non-issuer imply that the non-issuer is subject to, or otherwise complied with, some or all of the provisions of the Act and other securities laws or the Commission's rules and regulations thereunder?

A7. No. An auditor's reference to PCAOB standards in an audit report on the financial statements of a non-issuer does not subject the auditor or the non-issuer to any laws that the auditor or the non-issuer would not otherwise have been required to comply with. Unless the non-issuer is involved in an activity that subjects it to the Act or other securities laws, such as the laws governing broker-dealers, compliance by the auditor or the non-issuer with the Act or other securities laws would be strictly voluntary.

Q8. Does inclusion of a reference to the Board's standards in an auditor's report on the financial statements of a non-issuer cause the audit to become eligible for review as a part of a Board inspection?

A8. No. An audit of the financial statements of a non-issuer does not become subject to PCAOB inspection solely because the auditor performed and reported on the audit in accordance with the standards of the PCAOB. Auditors of the financial statements of non-issuers may, nevertheless, be subject to various forms of state and federal oversight, such as review by federal banking regulators, the U.S. General Accounting Office, or a state board of accountancy.

Q9. If a non-issuer elects to have its financial statements audited pursuant to the Board's standards, must it also have its internal control over financial reporting audited pursuant to the Board's Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Conducted in Conjunction with an Audit of Financial Statement"?

A9. No. Only certain issuers that are subject to Section 404 of the Act are required to include within the scope of the audit an audit of internal control over financial reporting. Although the Board's standards provide for an integrated audit of financial statements and internal control for those issuers that are subject to Section 404 of the Act, the Board's standards also permit auditors to conduct a financial statement-only audit under circumstances, for example, when Section 404 of the Act is not applicable.

Q10. If an auditor refers to either "the standards of the Public Company Accounting Oversight Board (United States)" or "the auditing standards of the Public Company Accounting Oversight Board (United States)" in an audit report on an audit of the financial statements of a non-issuer, is the auditor also required to subject the audit to a "concurring partner review" as required by the Board's adoption of certain of the requirements of the AICPA's former Securities and Exchange Commission Practice Section ("SECPS")?

A10. No. The Board may at some time adopt a standard requiring the performance of a second partner review. At this time, however, the PCAOB interim quality control standards only require registered firms that were members of the SECPS as of April 16, 2003, to have a concurring partner review on audits of issuers. (See PCAOB Release No. 2003-006.)

.02 STAFF QUESTIONS AND ANSWERS

Attest Engagements Regarding XBRL Financial Information Furnished Under the XBRL Voluntary Financial Reporting Program on the EDGAR System

May 25, 2005

Summary:

Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff questions and answers related to attest engagements regarding XBRL financial information furnished under the XBRL Voluntary Financial Reporting Program on the EDGAR System were prepared by the Office of the Chief Auditor. Additional questions should be directed to Keith Wilson, Associate Chief Auditor (202/207-9134; wilsonk@pcaobus.org).

* * *

Q1. What is XBRL?

A1. XBRL (eXtensible Business Reporting Language) is an open standard for electronic communication of business and financial data. The XBRL standard provides a format for tagging that data so users can extract, exchange, analyze, and present the information.

XBRL information is commonly distributed in the form of XBRL instance documents. These documents are electronic files consisting of financial data along with their corresponding XBRL tags.

To facilitate electronic communication of financial information among many parties, XBRL instance documents must be created using a common set of standards that all parties can understand and use. In XBRL, this is accomplished through taxonomies and specifications. An XBRL taxonomy (or tag list) provides a data structure and vocabulary for interpreting financial information, such as all of the items comprising "net income." An entity may extend the taxonomy by creating additional custom tags for its own use. XBRL specifications have been developed by the XBRL Consortium for creating and extending taxonomies. (See the XBRL website, www.xbrl.org, for more information about XBRL.)

Q2. What is the XBRL Voluntary Financial Reporting Program on the EDGAR System?

A2. The Securities and Exchange Commission ("SEC") has adopted rule amendments[1] allowing issuers to voluntarily submit supplemental tagged financial information using the XBRL[2] format as exhibits to specified EDGAR filings under the Securities Exchange Act of 1934 and the Investment Company Act of 1940. The amendments include certain requirements regarding the information in those exhibits. This SEC initiative is referred to in the SEC Release as the "XBRL Voluntary Financial Reporting Program on the EDGAR System" (hereinafter referred to as the "SEC Voluntary Program").

The XBRL documents furnished under the SEC Voluntary Program are referred to in the SEC Regulations[3] as "XBRL-Related Documents." The XBRL-Related Documents must contain only certain specified content ("mandatory content" and "optional content") that appears in a specified format ("voluntary program format"), as set forth in the SEC Regulations.

According to the EDGAR Filer Manual,[4] issuers who file under the SEC Voluntary Program must create their XBRL-Related Documents using one of the US Generally Accepted Accounting Principles ("US GAAP") taxonomies, based on XBRL Specification Version 2.1. Issuers also may use one of the Stand Alone Add-on taxonomies provided in the US Financial Reporting Taxonomy Framework for certain content. Any company extensions of those taxonomies must conform to XBRL Specification Version 2.1.

Q3. May an auditor[5] examine and report on whether the XBRL-Related Documents accurately reflect the information in the corresponding part of the official EDGAR filings? If so, what are the primary engagement standards that apply to those engagements?

A3. Yes, an auditor may be engaged to examine and report on whether the XBRL-Related Documents accurately reflect the information in the corresponding part of the official EDGAR filings. That engagement is an examination under AT section 101 of the PCAOB's interim attestation standards, *Attest Engagements* ("AT section 101"), as amended.

Q4. The second general attestation standard in paragraph .21 of AT section 101 indicates that the engagement shall be performed by an auditor "having adequate knowledge of the subject matter." How does this general standard apply to examination engagements regarding XBRL-Related Documents?

A4. In examination engagements regarding XBRL-Related Documents, the auditor must have sufficient knowledge of the applicable SEC Regulations, EDGAR Filer Manual requirements, and XBRL taxonomies and specifications to perform the examination. The auditor must also have sufficient knowledge

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[1] *Final Rule: XBRL Voluntary Financial Reporting Program on the EDGAR System*, Securities and Exchange Commission Release Nos. 33-8529, 34-51129, 3527944, 39-2432, IC-26747; File Number S7-35-04 (February 3, 2005) [70 FR 6556].

[2] The SEC's website, www.sec.gov, has more information about the SEC's XBRL initiative.

[3] § 232.401 of Regulation S-T, 17 C.F.R 232.401; and SEC Final Rule Release No. 33-8529 (February 3, 2005).

[4] EDGARLink Filer Manual, Appendix L. (The EDGARLink Filer Manual comprises Volume 1 of the EDGAR Filer Manual.)

[5] These PCAOB Staff Questions and Answers assume that the auditor who is engaged to perform this examination has also audited, in accordance with PCAOB standards, the financial statements for at least the latest period to which the XBRL financial information relates and the financial statements for the other periods covered by the XBRL financial information have been audited by the auditor or a predecessor auditor. Therefore, the word "auditor" is used instead of "practitioner."

of the company's financial statements and underlying financial records to understand how the financial data in the XBRL-Related Documents relates to the corresponding information in the official EDGAR filing.

Q5. The third general attestation standard in paragraph .23 of AT section 101 states that the auditor "shall perform the engagement only if he or she has reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users." How does this general standard apply to examination engagements regarding XBRL-Related Documents?

A5. Paragraphs .24 through .34 of AT section 101 discuss the attributes of suitable and available criteria. The US GAAP Version 2.1 based taxonomies, Stand Alone Add-on taxonomies, and XBRL Specification Version 2.1 would be considered suitable and available criteria because (a) they were developed by a panel of widely recognized experts that follow due process procedures, including exposure for public comment, and (b) they are available free of charge through the XBRL Consortium.

Company extensions of those taxonomies normally do not go through the same development processes as described in the preceding paragraph. Accordingly, the auditor should evaluate whether company extensions represent suitable and available criteria as described in AT section 101.

Q6. May the auditor assist a company with the creation or tagging of its XBRL-Related Documents and still perform an examination regarding those documents?

A6. The fourth general attestation standard requires the auditor to be independent in order to perform an attest engagement. When evaluating independence, the auditor should apply the independence principles for financial statement audits to the context of the examination engagement. For example, although the auditor may provide technical advice on matters related to the application of the XBRL taxonomy and specifications, the auditor's independence would be impaired (and thus the auditor would be unable to examine a company's XBRL-Related Documents) if he or she prepared those documents or made decisions about the documents for management.

Q7. What are the objectives of the examination procedures regarding the XBRL-Related Documents, and what procedures should be performed to achieve those objectives?

A7. In performing the examination as set forth in AT section 101, the auditor should apply procedures as necessary to obtain sufficient evidence to provide a reasonable basis for an opinion on whether the XBRL-Related Documents accurately reflect the information in the corresponding part of the official EDGAR filings. Thus, the objectives of the examination procedures are to determine whether—

a. the XBRL data agrees with the official EDGAR filings, and

b. the XBRL-Related Documents are in conformity with the applicable XBRL taxonomies and specifications, as well as with the SEC requirements for format and content.

The following are examination procedures that the auditor should consider to achieve the engagement objectives:

- Compare the rendered[6] XBRL-Related Documents to the information in the official EDGAR filing, and agree the corresponding content.
- Determine whether the content in the XBRL-Related Documents conforms to the SEC voluntary program content requirements.
- Determine whether the XBRL-Related Documents (and the related taxonomy documents, as necessary) conform to the SEC voluntary program format requirements. To accomplish this, the auditor should consider the following procedures:
    a. Test whether the data elements (i.e., text and line item names and associated values, dates and other labels) in the XBRL-Related Documents reflect the same information as the corresponding official EDGAR filing (i.e., the HTML or ASCII version).
    b. Verify that the data elements in the corresponding official EDGAR filing have not been changed, deleted, or summarized in the XBRL-Related Documents.
    c. Evaluate whether the XBRL-Related Documents comply with the appropriate XBRL specification and EDGAR-supported XBRL taxonomies.
    d. Evaluate whether any company extensions of the taxonomy are consistent with the SEC voluntary program format requirements, including conformity with XBRL specifications.
    e. Test whether data elements in the XBRL-Related Documents are matched with appropriate tags in accordance with the applicable taxonomy.
- Read the EDGAR filing to determine whether it contains the disclosures regarding XBRL-Related Documents required by SEC Regulations.[7]
- Obtain a representation letter from management that includes a statement that the XBRL-Related Documents comply with SEC requirements.

Q8. What are the reporting requirements for examination engagements regarding XBRL-Related Documents?

A8. The report for this engagement should comply with the requirements of AT section 101, as amended.

If the underlying information in the XBRL-Related Documents has been audited, the examination report should refer to the audit report. If the underlying information was reviewed, and the review report was filed with the SEC, the examination report should refer to the review report. If the underlying information was reviewed, but the review report was not filed with the SEC, the examination report need not refer to the review report but should indicate that the underlying information has not been audited and no opinion is expressed on it. The auditor should disclaim an opinion on any underlying information in the XBRL-Related Documents that is not covered by an audit report or review report.

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[6] A rendered XBRL-Related Document has been converted from machine readable form into human readable form using a software tool.

[7] § 232.401(d) of Regulation S-T, 17 C.F.R. 232.401(d).

The auditor may be engaged to report on management's assertion or on the subject matter of the assertion. The following are examples of examination reports for these engagements.

Report on the Subject Matter of the Assertion

Report of Independent Registered Public Accounting Firm on XBRL-Related Documents

We have examined the accompanying XBRL-Related Documents of Sample Volunteer Company, presented as Exhibit [*number*] to the Company's [*Identify EDGAR filing, such as Form 10-K*], which reflect the data presented in the [*Identify corresponding information in the official EDGAR filing*] as of [*Month and Day*], [*Year*] and [*Year*] and for each of the years in the [*number*]-year period ended [*date*]. Sample Volunteer Company's management is responsible for the XBRL-Related Documents. Our responsibility is to express an opinion based on our examination.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the financial statements of Sample Volunteer Company as of [*Month and Day*], [*Year*] and [*Year*] and for each of the years in the [*number*]-year period ended [*date*], and in our report dated [*date*], we expressed an unqualified opinion on those financial statements.[8] In addition, we have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Sample Volunteer Company's internal control over financial reporting as of [*Month and Day*],

[*Year*], based on [*Identify control criteria*], and our report dated [*date*], expressed [*Include nature of opinion*].[9] [10] [11] [12]

Our examination was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and, accordingly, included examining, on a test basis, evidence supporting the XBRL-Related Documents. Our examination also included evaluating the XBRL-Related Documents for conformity with the applicable XBRL taxonomies and specifications

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[8] If the auditor's opinion on the related financial statements is other than unqualified, this report should disclose that fact along with the reason for the modified report.

[9] This sentence is necessary if (a) the XBRL-Related Documents include information about the effectiveness of internal control over financial reporting, and (b) that information was covered by an audit report.

[10] If the financial statements have been reviewed and the review report was filed with the SEC, this paragraph should read: "We have also reviewed, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the financial statements of Sample Volunteer Company as of [*date*], and for the three months then ended, the objective of which was the expression of limited assurance on such financial statements, and issued our report thereon dated [*date*], [*Describe any modifications of such report*]. A review of financial statements is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion."

[11] If the financial statements have been reviewed but the review report was not filed with the SEC, this paragraph should read: "We did not audit the financial statements of Sample Volunteer Company (or examine [*Identify any other underlying information*]), the objective of which would have been the expression of an opinion on them. Accordingly, we do not express an opinion on them.

[12] If the XBRL-Related Documents contain both (a) financial statements that are covered by an audit report or review report filed with the SEC and (b) other information that is not covered by an audit or review report, this paragraph should include a statement such as the following: "We were not engaged to and did not conduct an audit (or review) of [*Identify information*], the objective of which would have been the expression of an opinion (or limited assurance) on such [*Identify information*]. Accordingly, we do not express an opinion or any other assurance on [*it*] [*them*]."

and the content and format requirements of the Securities and Exchange Commission. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, the XBRL-Related Documents of Sample Volunteer Company referred to above accurately reflect, in all material respects, the data presented in the [*Identify corresponding information in the official EDGAR filing*] in conformity with [*Identify the criteria—for example, the taxonomy, such as "US GAAP—Commercial and Industrial Taxonomy," and where applicable, the Stand Alone Add-on Taxonomy such as "US Financial Reporting—Management Report Taxonomy," and the specifications, such as "XBRL Specifications (Version 2.1)*"].

[*Signature*]

[*City and State or Country*]

[*Date*]

Report on Management's Assertion[13]

Report of Independent Registered Public Accounting Firm on XBRL-Related Documents

We have examined management's assertion that [*Identify the assertion—for example, the accompanying XBRL-Related Documents, presented as Exhibit [number] to Sample Volunteer Company's [Identify EDGAR filing, such as Form 10-K] accurately reflect the data presented in the [Identify corresponding information in the official EDGAR filing*] as of [*Month and Day*], [*Year*] and [*Year*] and for each of the years in the [number]-year period ended [*date,*] in conformity with [*Identify the criteria—for example, the taxonomy, such as "US GAAP—Commercial and Industrial Taxonomy," and where applicable, the Stand Alone Add-on Taxonomy such as "US Financial Reporting—Management Report Taxonomy," and the specifications, such as "XBRL Specifications (Version 2.1)*"]. Sample Volunteer Company's management is responsible for the assertion. Our responsibility is to express an opinion on the assertion based on our examination.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the financial statements of Sample Volunteer Company as of [*Month and Day*], [*Year*] and [*Year*] and for each of the years in the [*number*]-year period ended [*date*], and in our report dated [*date*], we expressed an unqualified opinion on those financial statements. In addition, we have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Sample Volunteer Company's internal control over financial reporting as of [*Month and Day*], [*Year*], based on [*Identify control criteria*], and our report dated [*date*], expressed [*Include nature of opinion*].

Our examination was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and, accordingly, included examining, on a test basis, evidence supporting the XBRL-Related Documents. Our examination also included evaluating the XBRL-Related Documents for conformity with the applicable XBRL taxonomies and specifications and the content and format requirements of the Securities and Exchange Commission. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, management's assertion referred to above is fairly stated, in all material respects, in conformity with [*Identify the criteria—for example,*

[13] See the footnotes to the preceding report example.

the taxonomy, such as "US GAAP—Commercial and Industrial Taxonomy," and where applicable, the Stand Alone Add-on Taxonomy such as "US Financial Reporting—Management Report Taxonomy," and the specifications, such as "XBRL Specifications (Version 2.1)"].

[*Signature*]

[*City and State or Country*]

[*Date*]

.03 STAFF QUESTIONS AND ANSWERS

Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor

June 9, 2006

Summary:

Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff questions and answers related to adjustments to prior-period financial statements audited by a predecessor auditor were prepared by the Office of the Chief Auditor. Additional questions should be directed to Greg Scates, Associate Chief Auditor (202/207-9114; scatesg@pcaobus.org) or Sam Guzman, Assistant Chief Auditor (202/207-9117; guzmans@pcaobus.org).

General

Q1. Circumstances arise that require a company to make adjustments to prior-period financial statements. Such circumstances include, for example, the reporting of discontinued operations, and the retrospective application of a change in accounting principle or the correction of an error in prior-period financial statements pursuant to Financial Accounting Standards Board Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("FASB Statement 154").[1]

If the prior-period financial statements that require adjustments were audited by a predecessor auditor, which auditor, the predecessor or the successor, may audit the adjustments to prior-period financial statements?[2]

A1. Either the successor auditor or the predecessor auditor may audit the adjustments made to prior-period financial statements so long as the auditor is independent and registered with the PCAOB. Issuers sometimes select the

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[1] Pursuant to Financial Accounting Standards Board Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("FASB Statement 154"), the retrospective application of a change in accounting principle also is appropriate when there are no transition requirements specific to a particular accounting pronouncement.

[2] The term "adjustments to prior-period financial statements" should be understood for purposes of this set of questions and answers to include, among other things, the reporting of discontinued operations, as well as, restatements to correct errors and retrospective applications of changes in accounting principles, as described in FASB Statement 154.

predecessor auditor to audit the adjustments because that auditor has performed the audit of the prior-period financial statements and has knowledge of the transactions that occurred during that period. In addition, the use of the predecessor auditor sometimes can be more cost-effective for performing this work. However, the successor auditor also may audit the adjustments.

Predecessor Auditor Audits the Adjustments to Prior-Period Financial Statements

Q2. If the predecessor auditor audits the adjustments to the prior-period financial statements, how should the predecessor auditor date his or her report on the reissued financial statements?

A2. The predecessor auditor should dual-date his or her reissued report in connection with the audit of the adjustments made to the prior-period financial statements. Paragraph .73 of AU section ("sec.") 508, *Reports on Audited Financial Statements*, states that, "A predecessor auditor's knowledge of the current affairs of his or her former client is obviously limited in the absence of a continuing relationship. Consequently, when reissuing the report on prior-period financial statements, a predecessor auditor should use the date of his or her previous report to avoid any implication that he or she has examined any records, transactions, or events after that date. If the predecessor auditor revises the report or if the financial statements are restated, he or she should dual-date the report."

Q3. If the predecessor auditor audits the adjustments made to the prior-period financial statements, what is the successor auditor's responsibility with regard to those adjustments?

A3. If the predecessor auditor audits the adjustments made to the prior-period financial statements, he or she is responsible for the audit conclusions reached with respect to those adjustments. However, because corrections of errors and the retrospective application of a change in accounting often have the effect of changing the periods in which transactions and events are recognized in the financial statements, the successor auditor should obtain an understanding of the adjustments made to the prior-period financial statements and their effects, if any, on the current-period financial statements.[3]

In addition, the successor auditor should evaluate the consistency of the application of accounting principles from period to period. Paragraph .24 of AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*, states:

> When the independent auditor has not audited the financial statements of a company for the preceding year, he should adopt procedures that are practicable and reasonable in the circumstances to assure himself that the accounting principles employed are consistent between the current and the preceding year.

Successor Auditor Audits the Adjustments to Prior-Period Financial Statements

Q4. What factors are relevant to a successor auditor's determination as to whether he or she is able to audit only the adjustments to prior-period

[3] See the requirement for the auditor to plan and perform his or her work with due professional care in paragraph .02 of AU section ("AU sec.") 230, *Due Professional Care in the Performance of Work*.

financial statements or whether a reaudit of those financial statements is necessary?[4]

A4. To audit only the adjustments to prior-period financial statements that were audited by a predecessor auditor,[5] a successor auditor must be able to form an opinion that the adjustments are appropriate and have been properly applied.[6] In determining whether he or she is able to form such an opinion without performing a reaudit of the prior-period financial statements, the successor auditor should consider:

- *The extent of the adjustments.* The less extensive and pervasive the adjustments to prior-period financial statements are, the more likely it is that a successor auditor can form an opinion that the adjustments are appropriate and have been properly applied without performing a reaudit of those financial statements. More extensive and pervasive adjustments make it more likely that a reaudit is necessary.
- *The reason for the adjustments.* A successor auditor is ordinarily more likely to be able to form an opinion that adjustments to prior-period financial statements are appropriate and have been properly applied when those adjustments are due to the retrospective application of an accounting principle rather than when the adjustments are necessary to correct an error.[7] In the latter situation, the auditor should consider the risk that there may be other undetected misstatements in the prior-period financial statements. In particular, if the adjustments correct an intentional misstatement,[8] it is more likely that a reaudit is necessary.
- *Cooperation of predecessor auditor.* A successor auditor is more likely to be able to form an opinion that adjustments to prior-period financial statements are appropriate and have been properly applied if he or she has the cooperation of the predecessor auditor. For example, a successor auditor may determine that he or she is able to audit adjustments to prior-period financial statements if he or she has access to the audit documentation relating to the prior periods and if the predecessor auditor is responsive to questions relating to those periods.

After a successor auditor has determined that he or she is likely to be able to form an opinion that adjustments to prior-period financial statements are appropriate and have been properly applied, the auditor might obtain evidence indicating, or otherwise might determine, that the prior-period financial statements are materially misstated in other respects. In this circumstance, the successor auditor should reevaluate whether auditing only the adjustments is

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[4] This staff question and answer assumes that the predecessor auditor reissues his or her report on the prior-period financial statements before the effects of the adjustments.

[5] This series of staff questions and answers assumes that the predecessor auditor has not ceased operations as the term "ceased operations" has been defined in footnote 2 of AU sec. 9508, *Reports on Audited Financial Statements: Auditing Interpretations of Section 508*. In cases in which the predecessor auditor has ceased operations, the successor auditor should refer to AU sec. 9508.60–.75.

[6] See paragraph .74 of AU sec. 508, *Reports on Audited Financial Statements*.

[7] FASB Statement 154 defines an error in previously issued financial statements as an error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of GAAP, or oversight or misuse of facts that existed at the time the financial statements were prepared. Errors, also referred to as misstatements, include those that are intentional or unintentional.

[8] See paragraph .05 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

appropriate or whether a reaudit of the prior-period financial statements is necessary.[9]

Q5. If the successor auditor audits adjustments to the prior-period financial statements audited by a predecessor auditor, how should the successor auditor report on the results of the audit of those adjustments?

A5. AU sec. 508.74 describes how a successor auditor should report when he or she audits adjustments and the predecessor auditor's report is not presented. The successor auditor may use a similar form of reporting if he or she has audited the adjustments made to prior-period financial statements in connection with his or her audit of a subsequent period and if the predecessor auditor also reissues his or her report on the prior-period financial statements. It also is appropriate for the successor auditor to emphasize in the report that he or she was not engaged to audit, review, or apply any procedures to the prior-period financial statements other than with respect to the adjustments.

The following are examples of a paragraph the successor auditor may include in his or her report on the audit of the financial statements of a subsequent period:

Example for retrospective application of a change in accounting

> We also have audited the adjustments to the 20X4 financial statements to retrospectively apply the change in accounting [*describe accounting change*], as described in Note X. In our opinion, such adjustments are appropriate and have been properly applied. We were not engaged to audit, review, or apply any procedures to the 20X4 financial statements of the Company other than with respect to the adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 20X4 financial statements taken as a whole.

Example for correction of an error

> We also have audited the adjustments described in Note X that were applied to restate the 20X4 financial statements to correct an error. In our opinion, such adjustments are appropriate and have been properly applied. We were not engaged to audit, review, or apply any procedures to the 20X4 financial statements of the Company other than with respect to the adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 20X4 financial statements taken as a whole.

Q6. When a successor auditor audits and reports on adjustments made to prior-period financial statements due to the correction of an error, may the predecessor auditor reissue his or her report on the prior-period financial statements?

A6. Yes. A predecessor auditor may reissue his or her report on prior-period financial statements when a successor auditor has been engaged to audit and report on adjustments made to those prior-period financial statements, provided that the predecessor auditor has determined that the report on those financial statements is still appropriate, other than with respect to the error correction.[10] When determining whether the report is still appropriate, the predecessor auditor may consider factors such as:

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[9] In addition, the successor auditor has responsibilities under paragraphs .21-.22 of AU sec. 315, *Communications Between Predecessor and Successor Auditors*, when the successor auditor becomes aware of information that leads him or her to believe that the prior-period financial statements reported on by the predecessor auditor may require revision.

[10] See AU sec. 508.71. The predecessor auditor also may decide to withdraw his or her report on those financial statements. See AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

- The nature and extent of the adjustments pertaining to the error correction,
- Whether management has withdrawn the prior-period financial statements, and
- Whether the errors were intentional.

Q7. If the predecessor auditor does not reissue his or her report on the prior-period financial statements, may the successor auditor reaudit and report on those financial statements as adjusted?

A7. Yes. A successor auditor or another independent auditor may reaudit and report on prior-period financial statements as adjusted.

Q8. In circumstances in which a successor auditor audits and reports on adjustments made to prior-period financial statements audited by a predecessor auditor, what procedures should the predecessor auditor perform prior to reissuing his or her report on those financial statements prior to adjustment?

A8. AU sec. 508.71 states that, "a predecessor auditor should (a) read the financial statements of the current period, (b) compare the prior-period financial statements that he or she reported on with the financial statements to be presented for comparative purposes, and (c) obtain representation letters from management of the former client and from the successor auditor. The representation letter from management of the former client should state (a) whether any information has come to management's attention that would cause them to believe that any of the previous representations should be modified, and (b) whether any events have occurred subsequent to the balance-sheet date of the latest prior-period financial statements reported on by the predecessor auditor that would require adjustment to or disclosure in those financial statements [except for the adjustments]. The representation letter from the successor auditor should state whether the successor's audit revealed any matters that, in the successor's opinion, might have a material effect on, or require disclosure in, the financial statements reported on by the predecessor auditor [other than the adjustments disclosed to the predecessor auditor]."

Q9. In circumstances in which a successor auditor audits and reports on adjustments made to prior-period financial statements audited by a predecessor auditor, are there any modifications the predecessor auditor should make to his or her reissued report on the prior-period financial statements?

A9. Yes. If the predecessor auditor was not engaged to audit the adjustments to the prior-period financial statements, the predecessor auditor should modify his or her reissued report to indicate that (a) the reissued opinion relates to the prior-period financial statements before the effects of the adjustments, and (b) he or she was not engaged to audit, review, or apply any procedures to the adjustments.

The following are examples of how the predecessor auditor may modify his or her report:[11]

Example for retrospective application of a change in accounting

Report of Independent Registered Public Accounting Firm

We have audited, before the effects of the adjustments to retrospectively apply the change in accounting described in Note X, the balance sheet of ABC Company as of December 31, 20X4, and the related statements of income, changes in shareholders' equity, and cash flows for the year then ended (the 20X4 financial

[11] See PCAOB staff question no. 6.

statements before the effects of the adjustments discussed in Note X are not presented herein). The 20X4 financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

[*Same second paragraph as the standard report*]

In our opinion, the 20X4 financial statements, before the effects of the adjustments to retrospectively apply the change in accounting described in Note X, present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X4, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

We were not engaged to audit, review, or apply any procedures to the adjustments to retrospectively apply the change in accounting described in Note X and, accordingly, we do not express an opinion or any other form of assurance about whether such adjustments are appropriate and have been properly applied. Those adjustments were audited by [*name of successor auditor*].

[*Signature*]

[*City and State or Country*]

[*Original Date*]

Example for correction of an error

Report of Independent Registered Public Accounting Firm

We have audited, before the effects of the adjustments for the correction of the error described in Note X, the balance sheet of ABC Company as of December 31, 20X4, and the related statements of income, changes in shareholders' equity, and cash flows for the year then ended (the 20X4 financial statements before the effects of the adjustments discussed in Note X [*have been withdrawn and*] are not presented herein). The 20X4 financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

[*Same second paragraph as the standard report*]

In our opinion, except for the error described in Note X, the 20X4 financial statements present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X4, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

We were not engaged to audit, review, or apply any procedures to the adjustments for the correction of the error described in Note X and, accordingly, we do not express an opinion or any other form of assurance about whether such adjustments are appropriate and have been properly applied. Those adjustments were audited by [*name of successor auditor*].

[*Signature*]

[*City and State or Country*]

[*Original Date*]

Q10. When a successor auditor audits and reports on adjustments made to prior-period financial statements audited by a predecessor auditor, how should the predecessor auditor date his or her report on the reissued financial statements?

A10. When the successor auditor has audited and reported on the adjustments made to the prior-period financial statements and the predecessor auditor is reissuing the report on the prior-period financial statements, the predecessor auditor should use the date of the previous report to avoid any implication that he or she has examined any records, transactions, or events after that date.[12]

Successor Auditor Has Not Completed an Audit

Q11. Can a successor auditor audit and report on the adjustments made to the prior-period financial statements if he or she has not yet completed an audit of the current-period financial statements?

A11. No. If the prior-period financial statements have been adjusted, the successor auditor may audit and report on the adjustments made to the prior-period financial statements in connection with the successor auditor's audit of the financial statements of the company for a subsequent period.[13] Unless the successor auditor has completed an audit of the financial statements of the company, he or she will not have sufficient knowledge of the company and its financial reporting to adequately plan and perform an audit of the adjustments to conclude on whether they are appropriate and have been properly applied. If the successor auditor has not completed an audit of a subsequent period, the successor auditor, or another independent auditor, may be engaged to reaudit the prior-period financial statements and audit the adjustments to those financial statements.

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[12] See AU sec. 508.73.

[13] See AU sec. 508.74.

.04 STAFF QUESTIONS AND ANSWERS

Auditing the Fair Value of Share Options Granted to Employees

October 17, 2006

Summary:

Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff questions and answers are applicable to audits of financial statements in circumstances in which a company has granted share options to employees that must be accounted for as compensation cost in conformity with Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, issued by the Financial Accounting Standards Board. These staff questions and answers were prepared by the Office of the Chief Auditor. Additional questions should be directed to Greg Fletcher, Assistant Chief Auditor (202/207-9203; fletcherg@pcaobus.org) or Jennifer Rand, Deputy Chief Auditor (202/207-9206; randj@pcaobus.org).

General

Q1. What is the purpose of these PCAOB staff questions and answers about auditing the fair value of employee share options?

A1. The purpose of these questions and answers is to help auditors implement the PCAOB's existing auditing standards when auditing the fair value of share options granted to employees. The Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 123, *Share-Based Payment* (revised 2004) ("FAS 123R"), which established the accounting requirements for companies that grant share options to employees and generally required that companies recognize as compensation cost the grant-date fair value of the award. In addition, the SEC staff issued Staff Accounting Bulletin 107 ("SAB 107") in March 2005, which, among other things, provides the Securities and Exchange Commission ("SEC") staff's views regarding the valuation of share-based payment arrangements for public companies. Based on these developments, the PCAOB staff believes that there is a need for guidance for implementing the existing auditing standards related to a company's accounting for the fair value of employee share options.[1]

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[1] This series of PCAOB staff questions and answers addresses the principles and procedures related to auditing the grant-date fair value of employee share options, which is a component of compensation cost associated with the issuance of employee share options. It does not address auditing

(continued)

Q2. Which auditing standards of the PCAOB provide direction on auditing the fair value of employee share options and what are the general steps involved in auditing them?

A2. Because employee share options are complex financial instruments with no available market, companies generally use option-pricing models to estimate the fair value. As such, these valuations are accounting estimates, and AU sec. 342, *Auditing Accounting Estimates*, and AU sec. 328, *Auditing Fair Value Measurements*, most directly apply. In addition, because fraudulent financial reporting often is accomplished through an intentional misstatement of an estimate, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, also applies.[2]

In general, when auditing the fair value of employee share options, the auditor should:

- Obtain an understanding of the process used to develop the estimated fair value of employee share options;
- Assess the risk of misstatement related to the fair value of employee share options; and
- Perform testing on the company's estimated value of employee share options. Testing includes:
  - — Evaluating the consistency of the process,
  - — Evaluating the reasonableness of (1) the company's model and (2) the assumptions used in the model, such as expected term and expected volatility, and
  - — Verifying the accuracy and completeness of the data underlying the fair value measurements.

The auditor also should evaluate whether he or she possesses the necessary skills and knowledge to plan and perform the audit procedures.

Each of these matters is addressed in the following PCAOB staff questions and answers

The Company's Process

Q3. How should the auditor evaluate the company's process for estimating the fair value of employee share option grants?

A3. AU sec. 328.09 requires the auditor to obtain an understanding of the company's process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach.[3] AU sec. 328.23 states that, based on the auditor's assessment of the risk of

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(footnote continued)

the other components of determining and reporting compensation cost in the financial statements. Other components include making adjustments for actual pre-vesting forfeitures to arrive at the compensation cost related to the share option grant; determining the periods in which compensation cost is recognized in the financial statements; determining related financial statement effects of employee share options to the company, such as income tax effects; and making the appropriate entries in the general ledger.

[2] The Board adopted as its interim standards generally accepted auditing standards as described in the AICPA Auditing Standards Board's Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, as in existence on April 16, 2003, to the extent not superseded or amended by the Board, on an initial transitional basis.

[3] Paragraph .12 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, also provides items that auditors should consider when obtaining an understanding of fair value measurements and disclosures.

material misstatement, the auditor should test the entity's fair value measurements and disclosures. AU sec. 328.23 also identifies three ways in which the auditor may test fair value measurements:

- Testing management's significant assumptions, the valuation model, and the underlying data,
- Developing independent fair value estimates for corroborative purposes, or
- Reviewing subsequent events and transactions.[4]

Because of the complexity involved in developing an independent estimate and the limited usefulness of reviewing subsequent events and transactions to evaluate the fair value of employee share options, in many cases, the second and third approaches are not likely to be practical approaches to auditing the fair value of employee share options. In such cases, the auditor should test management's significant assumptions, the valuation model, and the underlying data related to the fair value estimate.

In applying the provisions of AU sec. 328 to the evaluation of the company's process for estimating the fair value of employee share option grants, the auditor should review the procedures used by the company to make the estimates. These procedures include:

- Evaluating how the terms of the share option awards affect the determination of the grant date, selection of model, and the assumptions used;[5]
- Selecting the option-pricing model;[6] (See also PCAOB staff question Nos. 5 and 6.)
- Developing the assumptions used in the valuation, including implementation of the guidance in FAS 123R and SAB 107,[7] that could affect the assumptions;[8] (See also PCAOB staff question Nos. 7–18.)
- Ensuring that the data upon which the fair value measurements are based (including employee exercises and post-vesting cancellations and lapses) are accurate and complete;[9] (See also PCAOB staff question No. 19.) and
- Generating the estimated fair value of the employee share options, including executing the calculations required in the option-pricing model.[10] (See also PCAOB staff question No. 20.)

The auditor also should evaluate whether the process is complete, including whether the company considers the relevant factors identified in the accounting

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[4] Similarly, in evaluating the reasonableness of an estimate, paragraph .10 of AU sec. 342, *Auditing Accounting Estimates*, requires the auditor to review and test the process used by management to develop an estimate, develop an independent estimate to corroborate the reasonableness of the company's estimate, or review subsequent events or transactions occurring before the completion of fieldwork.

[5] See Statement of Financial Accounting Standard No. 123, *Share-Based Payment* (revised 2004) ("FAS 123R"), paragraph A2.

[6] See FAS 123R, paragraphs A13–A15.

[7] See SEC Staff Accounting Bulletin 107, *Share-Based Payment* (March 29, 2005).

[8] See FAS 123R, paragraph A16.

[9] See AU sec. 328.39.

[10] Ibid.

literature that affect the assumptions and whether the company applies the process consistently from period to period.[11]

In addition, in auditing the financial statements, the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more assertions. In such circumstances, the auditor should obtain evidence about the effectiveness of both the design and operation of controls to reduce the assessed level of control risk.[12, 13]

Risk Factors

Q4. What factors affect the auditor's assessment of risk at the financial statement and significant account levels for fair value measurements related to employee share options?

A4. Accounts consisting of amounts derived from accounting estimates have a higher inherent risk than do accounts consisting of relatively routine factual data[14] or having readily determinable values. Therefore, compensation cost based on fair value measurements of employee share options, and related disclosures, often will have a high inherent risk. The auditor should be aware of how changes in assumptions and models affect fair value.

The following are examples of circumstances or conditions that indicate increased risk and might indicate a risk of fraud that would require a specific response from the auditor:[15]

- When an assumption that a company uses has the effect of reducing the fair value below what it would have been had the company based the assumption on unadjusted historical information.
- Exclusion of an historical period of time from the inputs to the valuation model, especially when the effect of that exclusion is to lower expected term or expected volatility.[16] (See also PCAOB staff question No. 14.)
- Adjustments to historical exercise behavior or historical share price volatility. For example:
  - — The expected term estimate for the current grant of share options is five years when the company has averaged seven years in previous grants of share options;
  - — The expected term or expected volatility estimate selected as the most likely was the lowest in a range of possible expected terms or expected volatilities; or

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[11] AU sec. 328.19 states that the auditor should evaluate whether the company's method (in this case, the company's process) for determining fair value measurements is applied consistently and if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the company, or changes in accounting principles.

[12] See AU sec. 319.03.

[13] In an integrated audit of the financial statements and internal control over financial reporting, the auditor must obtain evidence about the effectiveness of internal controls. This series of PCAOB staff questions and answers does not illustrate how the auditor should test the design and operating effectiveness of controls related to employee share option compensation cost and disclosures in an integrated audit.

[14] See AU sec. 312.27a.

[15] See AU sec. 316.48b.

[16] See also SAB 107, interpretive response to question 2, Section D.1. SAB 107 states that valid exclusions of periods would be rare.

— The expected term and expected volatility estimates are both lower than the historical averages.

- Adjustments to historical exercise behavior or historical share price volatility are not applied consistently to each option grant in circumstances in which they should have been consistently applied.

Model Selection

Q5. Observable market prices generally are not available for employee share options because employee share options are not traded. As a result, companies ordinarily will need to use an option-pricing model to estimate the fair value of employee share options. What factors should the auditor use to evaluate the reasonableness of a company's selection of an option-pricing model for calculating the fair value of employee share options?[17]

A5. The auditor should evaluate whether the model selected by the company

- Is applied in a manner consistent with FAS 123R's fair value measurement objective;
- Is based on established principles of financial economic theory; and
- Reflects all of the substantive characteristics of the share options granted to employees.[18]

The Black-Scholes-Merton formula, a closed-form option-pricing model, was developed for exchange-traded share options. As developed, it assumes that option exercises occur at the end of an option's contractual term, and that the other factors, expected volatility, expected dividends, and risk-free interest rates, are constant over the option's term. Because employees often exercise before the contractual term expires, FAS 123R requires companies to modify the term used as an input to the original formula by estimating an expected term for the employee share options that is less than the contractual term.

A lattice, or binomial, option-pricing model, however, can accommodate dynamic assumptions of expected volatility and dividends over the option's contractual term, and estimates of expected option exercise patterns during the contractual term (for example, the likelihood that an employee will exercise when the share price reaches a certain multiple of the exercise price). Therefore, the design of a lattice model might more fully reflect the substantive characteristics of a particular employee share option.[19]

The auditor should be alert to circumstances in which the selection of the Black-Scholes-Merton formula might not be appropriate. For example, the appropriate model for estimating the fair value of an instrument with a market condition (such as an exercise condition that is satisfied when the share price exceeds a specified value for a specified period of days) must take into account the effect of that market condition.[20] The Black-Scholes-Merton option-pricing formula

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[17] See FAS 123R, paragraph A2. The fair value of equity instrument share options granted to employees is measured on the date of the grant.

[18] See FAS 123R, paragraph A8, AU sec. 328.18, and AU sec. 328.26b. In addition to the Black-Scholes-Merton formula and a lattice option-pricing model, a Monte Carlo simulation technique also satisfies the requirements in paragraph A8 of FAS 123R. See FAS 123R, footnote 48.

[19] See FAS 123R, paragraph A15.

[20] See FAS 123R, paragraph A14.

would not generally be an appropriate valuation model for a share option in which the exercisability is conditional on a specified increase in the price of the underlying shares because it is not designed to take into account that type of market condition.[21]

Q6. What steps should the auditor take when a company changes the valuation technique or model chosen to value employee share options?

A6. The auditor should evaluate whether the new technique or model meets the fair value measurement objective of FAS 123R. The SEC staff has stated that it would not object to a company changing its valuation technique or model, as long as the new technique or model meets the fair value measurement objective.[22] SAB 107 states that a company should take into account the reason for the change in technique or model in determining whether it meets the fair value measurement objective.[23] However, the SEC staff also has stated that it would not expect that a company would frequently switch between valuation techniques or models, particularly when there has been no significant variation in the form of share-based payments being[24] As noted in SAB 107, changing a technique or model from period to period for the sole purpose of lowering the fair value estimate of a share option would not meet the fair value measurement objective of FAS 123R.[25] Finally, frequent changes in the valuation technique or model also might indicate a risk of fraud that would require a response by the auditor. Accordingly, the auditor should evaluate management's reason for the change.

Assumptions Used In Option-Pricing Models

Q7. Paragraph A18 of FAS 123R states that the valuation technique or model used to estimate the fair value of the share option shall take into account, at a minimum—

- Expected term of the option (in a lattice model, expected term is an output of the model);
- Expected volatility of the price of the underlying share for the expected term of the option;
- Exercise price of the option;
- Current price of the underlying share;
- Risk-free interest rate(s) for the expected term of the option; and
- Expected dividends of the underlying share for the expected term of the option.

How should the auditor assess the possible effect of these six items on the fair value measurement?

A7. The expected term and expected volatility assumptions have the highest risk because they involve the greatest amounts of judgment and have a significant effect on the estimated fair value. PCAOB staff question Nos. 8 through 11. provide direction to the auditor regarding expected term. PCAOB staff question Nos. 12 through 17 provide direction to the auditor regarding volatility.

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[21] See the interpretive response to question 2, section C of SAB 107.

[22] See the interpretive response to question 3, section C of SAB 107.

[23] Ibid.

[24] Ibid.

[25] Ibid.

The exercise price of the option and current price of the underlying shares have a significant effect on the fair value measurement and have a high degree of verifiability. The auditor should verify that the company has properly authorized the share option plan and test whether the company has properly authorized the specific terms of the award, correctly determined the grant date, and accurately entered the exercise price and current share price, as of the measurement date, into the valuation model.

The risk-free interest rate(s) might have an elevated risk because a mathematical computation could be involved. The expected dividends assumption might have an elevated risk because of potential measurer bias. PCAOB staff question No. 18 provides direction to the auditor regarding risk-free interest rate(s) and expected dividends.

Expected Term of the Option

Q8. The expected term assumption is one of the key drivers of fair value in the Black-Scholes-Merton formula.[26] Paragraph A23 of FAS 123R states that assumptions used to estimate the fair value of share options granted to employees should be determined in a consistent manner from period to period. How should the auditor evaluate the reasonableness of the expected term assumption?

A8. When a company is using the Black-Scholes-Merton option-pricing formula, the auditor should apply the following procedures to the expected term assumption:[27]

- Obtain an understanding of the company's process for estimating expected term, including the extent to which the company evaluates relevant factors in the accounting literature;[28]
- Verify that the expected term generally is at least equal to the vesting period of the share option grant;[29]
- Verify that the company (1) has taken into account the contractual term of the option and the effects of employees' post-vesting employment termination behavior, in addition to employees' expected exercise behavior, and (2) has not taken into account pre-vesting employee termination behavior;[30]
- Evaluate whether adjustments that the company has made to the historical exercise behavior are reasonable and supportable,[31] including adjustments to the historical exercise behavior of groups (See also PCAOB staff question No. 11); and

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[26] Expected term usually is an output of lattice models.

[27] See PCAOB staff question No. 10 for a discussion about the "simplified method." If a company's share option plan has the characteristics that are sometimes referred to as "plain vanilla," it may use the simplified method for estimating expected term, as found in SAB 107. However, the SEC staff has stated that it does not expect the simplified method to be used for share option grants after December 31, 2007.

[28] For example, see FAS 123R, paragraphs A26–A30.

[29] See FAS 123R, paragraph 42. Some awards have graded vesting schedules. These may be accounted for as in-substance multiple awards.

[30] Paragraphs A27 and A28 of FAS 123R describe factors that may affect expectations about employees' exercise behavior.

[31] See FAS 123R, footnote 50.

- Test the data that the company uses for its estimate, such as data on actual exercise behavior (See also PCAOB staff question No. 19).

The auditor also should evaluate whether the person or persons determining the expected term assumption, including the company's specialists, have experience in valuing employee share options[32] and assess how that evaluation affects the audit procedures.

Q9. What should the auditor do to test a company's calculation of its historical exercise experience for employee share options, including consideration of the contractual term and post-vesting employee behavior?

A9. Paragraph A21 of FAS 123R states that historical experience generally is the starting point for developing expectations about the future. Because the expected term estimate is the period of time for which the option is expected to be outstanding (that is, generally the period of time from the grant date to the date of expected exercise or other expected settlement), companies may start by calculating a historical weighted average period of time for which previous grants of share options were outstanding.

The auditor should verify that a company's calculations include options that were not exercised during the contractual term. Failure to include such options could significantly understate average time that options were outstanding. For example, if a company calculates historical exercise behavior based only on the 70 percent of the options exercised over a 10 year contractual term, then it will probably significantly understate the average by not considering the 30 percent of options that may have been outstanding for 10 years and never exercised.

The auditor should:

- Evaluate whether the company's calculations are complete; i.e., that the calculations include all vested options, including those that were never exercised;
- Evaluate whether the company's calculations are mathematically correct, including any separate calculations for groups of employees (See also PCAOB staff question No. 11); and
- Test the underlying data upon which the company's calculations are based, for example, the grant date and exercise date (See also PCAOB staff question No. 19).

The auditor also should be aware of situations in which historical information is not sufficiently complete to enable a company to use it as the sole basis for estimating expected term. For example, if a company issues employee share options for the first time in 20X4 with a three-year vesting period and a ten-year contractual term, it cannot use its unadjusted historical experience in estimating the expected term of additional grants in 20X8 because there will have been only one year in which the earlier grants could have been exercised. The earliest it will have a complete history is at the end of the ten-year contractual term.

In situations in which the company calculated the historical exercise behavior based on incomplete historical information, the auditor should evaluate whether the company's rationale for using this calculation in connection with an estimate of expected term is reasonable and supportable.

Q10. FAS 123R states that expectations based on historical experience should be modified to reflect ways in which currently available information

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[32] See AU sec. 328.12.

indicates that the future is reasonably expected to differ from the past.[33] What procedures should the auditor perform to evaluate the reasonableness of adjustments to historical exercise behavior?

A10. The auditor should evaluate whether the company's rationale for adjustments to historical exercise behavior are reasonable and supportable.[34] The auditor also should evaluate whether the company failed to make a necessary adjustment. For example, if the historical experience is based on grants with one-year vesting, an adjustment would be appropriate if current grants have four-year vesting. The volatility of the company's stock price also can affect whether vested employees (1) exercise the options, (2) terminate from the company and exercise the options, (3) terminate from the company and let the options lapse, or (4) stay with the company through the contractual term and let the options lapse. Announced plans for acquisitions, divestitures, and initial public offerings of stock also could affect employee exercises and forfeitures.

The auditor should evaluate whether the amount of an adjustment is reasonable by reviewing the support for the adjustment. The auditor also should be alert to the risk of management override in the adjustments.

Range of expected terms. If a company, after analyzing its historical data, developed a range of possible expected terms that are each equally likely, the auditor should verify that the company selected the average of the amounts in the range (the expected value according to paragraph A20 of FAS 123R).

Use of SAB 107 "simplified method." According to SAB 107, the simplified method of estimating expected term is permitted only for "plain vanilla" options.[35] If a company uses the simplified method, the auditor should review the evidence that supports the company's view that it is eligible to use the simplified method. Specifically, the auditor should review the grant documentation to ensure that the terms conform to the "plain-vanilla" requirements, review pre-vesting terminations to ensure that the associated share options were cancelled, and test whether exercises by terminated employees occurred within a limited time after termination (typically 30 to 90 days).

Q11. According to FAS 123R, aggregating individual awards into relatively homogenous groups, with respect to exercise and post-vesting employment termination behaviors, and estimating the fair value of the options granted to each group separately, reduces the risk of potential misstatement of the value of the award.[36] How should the auditor evaluate the appropriateness of groups of employees used in the estimate of expected term?

A11. If the company segregates the employees into more than one group (such as executives and non-executives), the auditor should perform the following procedures to evaluate the company's employee groups:

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[33] See FAS 123R, paragraph A21.

[34] AU sec. 328 provides general guidance about evaluating a company's assumptions.

[35] The interpretative response to question 5, section D.2 of SAB 107, establishes basic characteristics of share option plans that are sometimes referred to as "plain vanilla." The basic characteristics are: (1) share options are granted at-the-money, (2) exercisability is conditional only on performing service through the vesting date, (3) if an employee terminates service prior to vesting, the employee would forfeit the share options, (4) if an employee terminates service after vesting, the employee would have a limited time to exercise the share options (typically 30 to 90 days), and (5) share options are nontransferable and nonhedgeable. In addition, the SEC staff has stated that it does not expect the simplified method to be used for share option grants after December 31, 2007 (See the interpretative response to question 6, section D.2.).

[36] See FAS 123R, paragraph A30. In addition, the interpretive response to Question 4 of section D.2. of SAB 107 states that an entity may generally make a reasonable fair value estimate with as few as one or two groupings.

- Evaluate whether the company aggregated individual awards into relatively homogeneous groups with respect to exercise and post-vesting employment termination behaviors and the evidence and rationale supporting the determination of the groups is adequate;
- Evaluate the reasonableness and completeness of groups;
- Evaluate the reasonableness and support for adjustments to historical exercise behavior of groups;
- Test the underlying data upon which the groups are based (See also PCAOB staff question No. 19); and
- Evaluate whether the company's calculations of historical exercise behavior for each group are mathematically correct.

Expected Volatility

Q12. Paragraph A23 of FAS 123R states that assumptions used to estimate the fair value of share options granted to employees should be determined in a consistent manner from period to period. Paragraphs A32 and A34 provide further guidance related to the company's estimate of expected volatility. How should the auditor evaluate the reasonableness of a company's estimate of the expected volatility of its share price?

A12. The auditor should perform the following procedures to evaluate the reasonableness of a company's estimate of expected volatility:[37]

- Obtain an understanding of the company's process for estimating expected volatility.
- Evaluate whether the company's process considers all of the applicable factors identified in paragraph A32 of FAS 123R in determining its estimate of expected volatility. The auditor also should evaluate whether the process (1) identifies the information necessary to be able to consider the volatility factors and (2) evaluates and weights that information (as required by paragraph A34 of FAS 123R).
- Evaluate the reasonableness of the assumptions, supporting information, judgments, and weightings. Evidence of reasonableness includes whether the company considered all the volatility factors and how such factors might affect the company's estimate of expected volatility. The auditor also should be alert to the risk of management override of the company's process for estimating expected volatility.
- Evaluate the consistency of the company's process for estimating expected volatility from period to period in evaluating the company's compliance with paragraphs A32 and A34 of FAS 123R.[38] However, the auditor also should consider that when circumstances indicate the availability of new or different information which would be useful in estimating expected volatility, SAB 107 directs the company to incorporate that information.[39]

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[37] AU secs. 342 and 328 provide general guidance for reviewing a company's process and evaluating its assumptions.

[38] The interpretative response to question 1, section D.1. of SAB 107 states that the process used to gather and review available information to estimate expected volatility should be applied consistently from period to period.

[39] Ibid.

- In general, for historical volatility, verify that the company's process provides for looking back over the expected term (for a closed-form model) or contractual term (for a lattice model)[40] to consider the extent to which currently available information indicates that future volatility will differ from historical volatility.[41] A change in a company's business model that results in a material alteration to the company's risk profile is an example of a circumstance in which the company's future volatility would be expected to differ from its past volatility.[42]
- Test the underlying data used in the estimate (See also PCAOB staff question No. 19).

The auditor also should evaluate whether the person or persons determining the expected volatility assumption, including the company's specialists, have experience in valuing employee share options,[43] and assess how that evaluation affects the audit procedures.

Historical Volatility

Q13. How should the auditor evaluate the reasonableness of a company's estimate of expected volatility when it uses its historical volatility as its expected volatility?

A13. As discussed in the answer to PCAOB staff question No. 12, the auditor should evaluate whether the company's process provides for looking backward to determine whether currently available information indicates that expected volatility will differ from historical volatility. The auditor should evaluate whether there is other information that the company did not consider and such information indicates that expected volatility will differ from the past. The auditor could base this evaluation on publicly available information related to the company's corporate history and future plans, and knowledge of the industry. In addition, an indication of the reasonableness of the company's process will be the extent to which the company analyzes each factor with respect to its own facts and circumstances.

Additionally, the auditor should consider the criteria established by SAB 107 for exclusive reliance on historical volatility. The SEC staff has stated that it would not object to a public company placing exclusive reliance on historical volatility when the following factors are present, and the methodology is consistently applied, if the company's common shares have been publicly traded for a sufficient period of time:[44]

- The company has no reason to believe that its future volatility over the expected or contractual term, as applicable, is likely to differ from its past;
- The computation of historical volatility uses a simple average calculation method;
- A sequential period of historical data at least equal to the expected or contractual term of the share option, as applicable, is used; and

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[40] See FAS 123R, paragraph A32a.

[41] See FAS 123R, paragraph A34.

[42] See SAB 107, footnote 55.

[43] See AU sec. 328.12.

[44] See SAB 107, section D.1., "Company B" example.

- A reasonably sufficient number of price observations are used, measured at a consistent point throughout the applicable historical period.

The auditor also should verify that the company has properly calculated the historical volatility.

If a company makes adjustments to historical volatility based on peer company data, the auditor should evaluate the reasonableness of the company's decision to use peer company data. In addition, the auditor should evaluate whether the company is using an appropriate peer group, the company is reasonably comparable to the peer group, and management reasonably blended peer group data and its own company data. The auditor also should be alert to the risk of management override in the area of adjustments to historical volatility.

Q14. FAS 123R indicates that a company should consider historical volatility over a period generally commensurate with the expected term or contractual term, as applicable. How should the auditor evaluate whether a company, in determining its expected volatility, has considered the historical volatility of its share price over an appropriate period of time?

A14. The auditor should evaluate whether the company considered the volatility of its share price over the most recent period that is generally commensurate with the expected term (or contractual term if a lattice model is used). For example, if a company estimated that the expected term of the options is four years, then the company generally should start with its historical volatility for the most recent four-year period in determining the expected volatility.

The following are circumstances that indicate increased inherent risk and might also indicate increased risk of fraud.

- The company used a period of historical data that is longer than the expected term,[45] and the effect is to lower expected volatility and the resulting fair value, or the company did not consistently use the longer period. Using a period of historical data longer than expected or contractual term is acceptable under SAB 107 if the company reasonably believes that the additional historical information will improve the estimate. However, this situation is similar to the condition described in PCAOB staff question No. 4, in which an adjustment to historical exercise behavior or share price volatility that results in a lower expected term or expected volatility increases inherent risk and might indicate a heightened risk of fraud.

- The company used a method that weights the most recent periods of a company's historical volatility more heavily than earlier periods, especially if the result is a lowering of expected volatility.[46]

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[45] See the interpretative response to question 2, section D.1 of SAB 107. SAB 107 also points out that paragraph A32a of FAS 123R indicates companies should consider historical volatility over a period generally commensurate with expected or contractual term.

[46] See SAB 107, interpretative response to question 2, section D.1, including footnote 40. SAB 107 states that such weighting may not be appropriate for longer term employee share options and that an estimate of expected volatility that places "extreme emphasis on the most recent periods" may not be consistent with paragraph A32(a) of FAS 123R.

- The company excludes a period of time from the calculation of historical volatility, especially if doing so results in a decrease of expected volatility, and hence a decrease in fair value.[47]

Q15. How should the auditor evaluate the company's share price observations for the purpose of determining historical volatility?

A15. The auditor should evaluate whether the company used actual observed prices within intervals that were appropriate based on the facts and circumstances and that provide a basis for a reasonable estimate. For example, if a company's shares are thinly traded, then weekly or monthly price observations may be more appropriate than daily price observations.[48] The auditor also should verify that the price observations are taken consistently throughout the period and are consistent with the approach used in prior grants. For example, if a company uses weekly price observations, then the auditor should verify that the company made the observation on the same day of each week. In addition, if the company changes when it makes price observations, for example, from daily price observations to monthly, the auditor should evaluate the reasonableness of the company's rationale for the change.

Implied Volatility

Q16. Implied volatility is inferred by calculating volatility using an option-pricing model (typically Black-Scholes-Merton), where the fair value—the market price of a company's appropriate traded financial instruments—and other variables are known (i.e., share price, exercise price, expected term, risk-free rate, and expected dividends). How should the auditor evaluate a company's use of implied volatility in its estimate of expected volatility?

A16. SAB 107 provides items for a company to consider when using implied volatility. Accordingly, in such situations, the auditor should evaluate whether a company with "appropriate traded financial instruments from which they can derive an implied volatility"[49] has appropriately taken into account implied volatility in determining the estimate of expected volatility.

For companies with exchange-traded options, or other appropriate traded financial instruments,[50] the auditor should evaluate whether the company's process for estimating expected volatility is appropriate and consistent from period to period.[51] A company that considers implied volatility will probably do so as part of its overall process for estimating expected volatility. Therefore, the auditor also should consider the concepts described in PCAOB staff question Nos. 3 and 12.

Regarding exclusive reliance on implied volatility, the SEC staff has stated that it would not object to a public company placing exclusive reliance on implied volatility when certain factors are present and the methodology is consistently

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[47] See SAB 107, interpretative response to question 2, section D.1. SAB 107 states that if a company disregards a period of historical volatility, it should be prepared to support its conclusion that its historical share price during that previous period is not relevant to estimating expected volatility due to one or more discrete and specific historical events and that similar events are not expected to occur during the expected term of the share option. SAB 107 states that these situations would be rare.

[48] See SAB 107, footnote 42.

[49] See SAB 107, interpretative response to question 1, section D.1.

[50] Ibid. Under SAB 107, appropriate traded financial instruments could include actively traded options or financial instruments with embedded options.

[51] See SAB 107, interpretative responses to question 3, section D.1, regarding the use of implied volatility.

applied, if the company's common shares have been publicly traded for a sufficient period of time and the company has multiple options on its shares outstanding that are traded on an exchange.[52]

If the company places exclusive reliance on implied volatility based on its assessment that the factors in SAB 107 are present, the auditor should evaluate that assessment. In addition, the auditor should verify that the company has properly calculated the implied volatility.

Combined Volatility

Q17. How should the auditor evaluate the reasonableness of a company's estimate of expected volatility when it uses a combination of historical and implied volatility in that estimate?

A17. The auditor should verify that the company's process for estimating expected volatility includes consideration of the applicable factors for using historical or implied volatility, as discussed in FAS 123R and SAB 107. PCAOB staff question Nos. 13 through 16 provide guidance for the auditor to use when evaluating the company's use of historical volatility, including the effects of any adjustments, and implied volatility in its estimate of expected volatility. In considering the reasonableness of the combined expected volatility, the auditor should evaluate the company's consideration of the factors that affect volatility, including the SEC staff's factors for exclusive use of implied or historical volatility, and the company's support for its conclusions. The factors outlined in SAB 107 for a company's exclusive use of either historical volatility or implied volatility also may provide some relative benchmarks for the auditor to use in evaluating the combined volatility.

Risk-Free Interest Rate(s) and Expected Dividends

Q18. FAS 123R requires that the valuation method, such as the Black-Scholes-Merton formula or lattice models, consider the expected dividends of the underlying shares for the expected term and the risk-free interest rate(s) for the expected term. How should the auditor evaluate whether the company has properly considered these two elements?

A18. The risk-free interest rate(s) and the expected dividends assumption generally are less subjective than the expected term and volatility assumptions and also do not have as significant an effect on the estimate of fair value. However, the auditor still should evaluate the reasonableness of those assumptions.

Risk-free interest rate. In general, the risk-free rate is the yield on a zero-coupon U.S. Treasury bond with a remaining term equal to the option term. A higher risk-free interest rate increases the option value and hence the estimated fair value, all other factors being equal.

If the company uses the Black-Scholes-Merton formula, the auditor should verify that the company used a traded zero-coupon U.S. Treasury bond with a remaining term equal to the expected term, measured on the grant date. The auditor also should verify that the company properly calculated the yield based on the traded price. If the company interpolated a yield because the expected term fell within the remaining terms of two bonds, the auditor should evaluate the accuracy of the interpolation.

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[52] See SAB 107, section D.1., Company B example, and interpretative response to question 4, section D.1.

If a company's lattice model incorporates a term structure of expected volatilities, the company might use a yield curve for the contractual period. If the company's lattice model uses a yield curve, the auditor should verify that the company properly calculated the yield curve and accurately entered the yields into the lattice model.

Expected dividends. The dividend yield over the option term affects the option value because it reduces the stock price on the ex-dividend date. In general, higher expected dividends decrease the value of the option and hence the estimated fair value. The auditor should:

- Evaluate whether the company has the intent and ability to pay the dividends that are embodied in the expected dividend assumption. Sufficient cash and observable trends provide evidence of the company's intent and ability to pay dividends.[53]
- If the company has adjusted its current or historic dividend yield, evaluate the reasonableness of and support for the expected dividend yield. The auditor should evaluate whether the expected dividend yield is consistent with management's plans and information available to market participants by reviewing evidence such as press releases on dividend policy changes and historical dividend yield rates. This evaluation should include whether the company failed to make an adjustment to expected dividends.
- Test the underlying data (See also PCAOB staff question No. 19).

Validation of Data and the Option-Pricing Model

Q19. How should the auditor test the underlying data that supports a company's estimate of fair value, and the related entries?

A19. Pursuant to AU sec. 328.39, the auditor should test the data used to develop the fair value measurements and evaluate whether the fair value measurements have been properly determined from such data and management's assumptions. This includes evaluating whether the data on which the fair value measurements are based, including the data used in the work of a specialist, are accurate, complete, and relevant; and whether fair value measurements have been properly determined using such data and management's assumptions. In considering the controls over data pursuant to AU sec. 328.12, the auditor should consider the effectiveness of the design of controls intended to safeguard the integrity and reliability of the data.

A number of systems, which can be automated or manual, often provide data relevant to the estimate of fair value. The auditor should identify the automated or manual systems that might be subject to testing. Record-keeping systems for stock plan information and awards are usually critical because information about forfeitures and exercises supports the company's estimate of expected term. Payroll, human resources, and tax systems also could be critical if they contain information about awards, forfeitures, and exercises that is used in the estimation process.[54]

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[53] AU sec. 328.17 states that the auditor should evaluate management's intent to carry out specific courses of action where intent is relevant to the use of fair value measurement and that the auditor also should evaluate management's ability to carry out those courses of action.

[54] See AU sec. 328.12. When obtaining an understanding of the company's process for determining fair value measurements and disclosures, the auditor should consider the extent to which the company relies on a service organization to provide data that supports the measurement. When a company uses a service organization, the auditor should consider the requirements of AU sec. 324, *Service Organizations*.

The auditor also should establish that any data used that resides outside the company are reliable, such as peer group data. AU sec. 329.16 provides guidance for evaluating the reliability of such data.

Q20. How should the auditor evaluate whether the model has appropriately calculated the fair value estimate for share options?

A20. If the company is using the Black-Scholes-Merton formula, the auditor should verify that the company is using the correct formula and recalculate the fair value. If the company is using a lattice option-pricing model, the auditor should obtain evidence that the model is functioning properly.

Role of Specialists

Q21. What is the role of a specialist in auditing estimates of the fair value of employee share option grants?

A21. AU sec. 328 provides guidance on auditing fair value measurements and disclosures, including auditing the fair value of employee share option grants. According to AU 328.12, as part of obtaining an understanding of the process management uses to determine fair value, such as the fair value of employee share option grants, the auditor should consider the extent to which management engages or employs specialists.

When testing fair value measurements and disclosures, the auditor should, among other things, perform procedures to evaluate whether management's assumptions are reasonable and to evaluate the source and reliability of evidence supporting management's assumptions.[55] According to AU sec. 328.05, footnote 2, management's assumptions include any assumptions developed by a specialist engaged or employed by management. Thus, the auditor should perform procedures in accordance with AU sec. 328 to evaluate the assumptions developed by a specialist engaged or employed by management.

Pursuant to AU sec. 328.20, the auditor should consider whether to engage a specialist and use the work of that specialist as evidential matter in performing substantive tests to evaluate material financial statement assertions related to the fair value of employee share option grants. In making this decision, the auditor[56] should evaluate whether he or she has the necessary skill and knowledge to plan and perform audit procedures related to the fair value of employee share option grants, including the reasonableness of the assumptions that the company or its specialist used.

The following circumstances related to the company's fair value measurement under FAS 123R often are particularly complex, involve assumptions that have a significant effect on fair value and, thus, might result in a higher assessment of risk by the auditor. Accordingly, the auditor should evaluate whether he or she has the necessary skill and knowledge to plan and perform audit procedures in these areas.

- Use of a lattice model, including obtaining evidence that the model is functioning properly. (See PCAOB staff questions No. 5, 18, and 20.)
- Exclusion of periods of historical data. (See PCAOB staff questions No. 4 and 14.)

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[55] See AU secs. 328.26a and 328.31.

[56] In this context, the term *auditor* includes employees of the auditor's firm who possess relevant special skill or knowledge and who participate in the audit as a member of the audit team.

- Adjustments to historical exercise behavior or historical share price volatility that result in shorter expected term or lower expected volatility than the company's historical experience. (See PCAOB staff questions No. 4, 10, and 14.)
- Use of a method that weights the most recent periods of a company's historical volatility more heavily than earlier periods, especially if the result is a lowering of expected volatility. (See PCAOB staff question No. 14.)
- Use of combined volatility. (See PCAOB staff question No. 17.)

Q22. What should the auditor do to satisfy the requirement that he or she evaluate the qualifications of a specialist?

A22. Valuation specialists may have certain areas of experience. When evaluating the qualifications of a specialist in accordance with AU sec. 336.08,[57] the auditor should evaluate whether the specialist has experience in valuing employee share options. In doing this, the auditor should evaluate the experience of the specialist's firm and of the individual specialist, or specialists, performing the service.

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[57] Pursuant to AU sec. 336.08a and b, the auditor should also consider the specialist's certification, license, or other recognition of competence and the specialist's reputation.

.05 STAFF QUESTIONS AND ANSWERS

Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees

April 3, 2007

Summary

Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff questions and answers related to ethics and independence rules concerning independence, tax services, and contingent fees were prepared by the Office of the Chief Auditor. Questions should be directed to Bella Rivshin, Associate Chief Auditor (202/207-9180; rivshinb@pcaobus.org) or Greg Scates, Associate Chief Auditor (202/207-9114; scatesg@pcaobus.org).

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Rule 3522. Tax Transactions

Q1. Does Rule 3522(a), Confidential Transactions, apply when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm?

A1. Yes. Under Rule 3522(a), a registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any non-audit service to the client related to marketing, planning, or opining in favor of the tax treatment of a confidential transaction. Under Rule 3501(c)(i)(1), a confidential transaction is a transaction that is offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a fee. As stated in the Board's adopting release, PCAOB Release 2004-015 (July 26, 2005), "Rule 3501(c) defines confidential transactions in terms of confidentiality restrictions imposed by tax advisors generally, not specifically auditors." Therefore, Rule 3522(a) applies not only when conditions of confidentiality have been imposed by a tax advisor that is employed by or affiliated with the registered public accounting firm, but also when conditions of confidentiality have been imposed by any tax advisor, including one that has no relationship with the registered public accounting firm.

Q2. For purposes of Rule 3522(a), Confidential Transactions, can a registered public accounting firm, when marketing, planning, or opining in favor of the tax treatment of a transaction, rely on representations from its audit

client that another tax advisor did not impose conditions of confidentiality in connection with the specific tax transaction?

A2. Yes. In determining if any tax advisor imposed conditions of confidentiality in connection with a specific tax transaction, the registered public accounting firm may rely on representations from its audit client, provided that the firm does not know, or have reason to know, that those representations are incorrect or incomplete.

Q3. In planning a tax transaction, may a registered public accounting firm advise an audit client on the tax consequences of alternative ways of structuring the transaction?

A3. Yes, as long as the auditor does not recommend an alternative tax transaction structure: (1) that is not more likely than not to be allowable under applicable tax laws, and (2) a significant purpose of which is tax avoidance. Rule 3522(b) provides that a registered public accounting firm is not independent of the audit client if the firm, or any affiliate of the firm, provides an audit client any non-audit service related to marketing, planning, or opining in favor of the tax treatment of a transaction that was initially recommended by the firm and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws. In planning a tax transaction for an audit client that is permitted under Rule 3522(b), the firm may need or want to inform the client about the tax consequences of alternative tax transaction structures, some of which may not be more likely than not to be allowable and have a significant purpose of tax avoidance. As long as the firm does not recommend that the audit client engage in such a transaction, the firm will not violate Rule 3522(b).

Q4. How is a registered public accounting firm's independence affected by the Internal Revenue Service's ("IRS") subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in Rule 3522(b), Aggressive Tax Position Transactions?

A4. The listing by the IRS of a transaction after the firm marketed, planned, or opined in favor of the tax treatment of the transaction would not retroactively affect the firm's independence. Whether the firm was independent when it planned, marketed, or opined in favor of the transaction would instead depend on the facts available at that time. An analysis under Rule 3522 would consider, among other things, whether the tax treatment of the transaction was, at the relevant time, at least more likely than not to be allowable under applicable tax laws, including whether the transaction was itself listed or substantially similar to a listed transaction.

After a transaction marketed, planned or opined on by the firm becomes listed, however, the firm's independence may, depending on the circumstances, become impaired. For example, even if a firm was independent at the time the tax transaction was executed, because it reasonably and correctly concluded the transaction was not the same as, or substantially similar to, a listed transaction, once a transaction is actually listed (or a substantially similar transaction becomes listed), the firm that participated in the transaction may find its independence impaired. In this situation, a mutuality of interest could be created by the fact that once a transaction is listed, the firm or client, or both, may be required to defend the tax treatment of the transaction and, in some cases, pay penalties. When a tax transaction in which the firm participated is subsequently listed (or is substantially similar to a transaction that is subsequently listed) by the IRS, the firm should evaluate the potential effect on its independence and discuss it, as appropriate, with the audit client's audit committee.

Rule 3523. Tax Services for Persons in Financial Reporting Oversight Roles

Q5. Rule 3523 restricts the provision of tax services to a person in a Financial Reporting Oversight Role ("FROR") at an audit client or an immediate family member of such person. FROR is defined under both SEC and PCAOB rules as a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them. For purposes of Rule 3522, must the auditor evaluate whether persons are in a FROR at any entities other than the one being audited?

A5. Yes. Auditors must evaluate whether a person is in a FROR at an "audit client." Because Rule 3501(a)(iv) defines "audit client" to include "any affiliates of the audit client," a person in a financial reporting oversight role at an affiliate of the audit client (and that person's immediate family members) are covered by Rule 3523, subject to two important exceptions. First, a firm's independence is not impaired under Rule 3523 if it provides tax services to a person who is in a financial reporting oversight role at the audit client (or an immediate family member of such a person) only because of the person's relationship to an affiliate whose financial statements are not material to the consolidated financial statements of the entity being audited. See Rule 3523(b)(1). Second, a firm's independence is not impaired under the rule if it provides tax services to a person who is in a financial reporting oversight role at the audit client (or an immediate family member of such a person) only because of the person's relationship to an affiliate whose financial statements are audited by an auditor other than the firm. See Rule 3523(b)(2).

Q6. What types of situations does the term "other change in employment event" in Rule 3523(c) encompass?

A6. Rule 3523(c) provides a time-limited exception to Rule 3523's restrictions on the provision of tax services to persons in financial reporting oversight roles at an audit client and certain of its affiliates. The exception applies when, among other things, a person becomes subject to the rule through a hiring, promotion, or "other change in employment event." Whether there has been an "other change in employment event" depends on the changed status of a person at an audit client. A change experienced by a company, such as a change in auditor or a change from a private company to a public one, is not, by itself, an "other change in employment event."

Some changes experienced by a company could, however, result in an "other change of employment event" for a particular person. For example, a person who is not in a financial reporting oversight role might, as a result of a business combination, be assigned additional duties and responsibilities that put him or her into a financial reporting oversight role. A business combination could also result in a change in a person's employer – for example, from an acquired company to a surviving company. A change in employer is also an "other change in employment event" under Rule 3523(c). For example, if Company A acquires Company B, a person who was in a financial reporting oversight role at Company B would experience an "other change in employment event" if he or she became an employee of Company A in a financial reporting oversight role as a result of the acquisition. If such a person had been receiving tax services from Company A's registered public accounting firm pursuant to an engagement in process before the acquisition, the time-limited exception in Rule 3523(c) would apply.

.06 STAFF QUESTIONS AND ANSWERS
Registration of Broker-Dealer Auditors

February 19, 2009

Summary:

The questions and answers below set forth staff guidance to assist auditors of non-public broker-dealers considering registration with the Public Company Accounting Oversight Board ("PCAOB" or "Board"). This guidance does not constitute Board rules, nor has it been approved by the Board.

The staff questions and answers below were prepared by the Division of Registration and Inspections to supplement PCAOB Release No. 2003-011B, *Frequently Asked Questions Regarding Registration with the Board*. Questions should be directed to the PCAOB's registration staff, by emailing registrationhelp@pcaobus.org or by calling 202-207-9329. The Securities and Exchange Commission ("SEC") staff and the Financial Industry Regulatory Authority ("FINRA") have also each published guidance on issues related to the requirement that auditors of non-public broker-dealers register with the Board. The SEC staff guidance can be found at www.sec.gov/divisions/marketreg/faqpcaobregbdauditors.htm. The FINRA guidance can be found at www.finra.org/Industry/Regulation/Notices/2009/P117689.

* * *

Overview of Registration

Q1. My firm audits broker-dealers but does not audit or participate in audits of public companies. Does my firm have to register with the Board?

A1. Yes. Section 17(e) of the Securities Exchange Act of 1934 (as amended by the Sarbanes-Oxley Act of 2002) provides that every registered broker or dealer shall annually file with the SEC certain financial statements that are certified by a firm that is registered with the PCAOB. Until recently, an order of the Securities and Exchange Commission (the "SEC Order") had provided non-public broker-dealers with relief from that requirement. As a result of the SEC Order's recent expiration, financial statements of non-public broker-dealers for fiscal years ending after December 31, 2008 must be certified by a registered public accounting firm.

Q2. What does my firm have to do to become registered with the Board?

A2. To register with the Board, your firm must submit a registration application and the Board must approve it. Links to the instructions to Form 1 and to Section 2 of the Board's rules (which govern the registration process) may be found at http://pcaobus.org/Rules/Pages/default.aspx. You may also view a sample registration application by clicking on "Sample Registration Form 1" located on the Registration page of the Board's website (www.pcaobus.org/Registration). You can read a discussion of the information Form 1 requires by going to http://pcaobus.org/Rules/Rulemaking/Pages/Docket001.aspx and clicking on Release 2003-007. The Board has also published answers to

frequently asked questions concerning the application process generally, which you can find on the Registration page. This document, PCAOB Release No. 2003-011B, *Frequently Asked Questions Regarding Registration with the Board*, is referred to below as "Board FAQs" and can be found at http://pcaobus.org/Registration/Information/Documents/Registration_FAQ.pdf.

In addition to submitting the Form 1 registration application, your firm will have to pay a non-refundable registration fee prior to Board consideration of your application. If your firm audited no issuers during the previous calendar year, the registration fee is $250. "Issuer" is defined in the Sarbanes-Oxley Act of 2002 and PCAOB rules and does not include a non-public broker-dealer.

Q3. Will PCAOB registration affect the manner in which my firm audits broker-dealers?

A3. The Board does not determine, inspect for compliance with, or enforce the standards applicable to audits of entities that are not issuers. In addition, the SEC staff has published guidance indicating that the requirement to register with the PCAOB does not affect the existing requirement, under SEC rules, that audits of the financial statements of non-public broker-dealers be conducted according to generally accepted auditing standards. See "PCAOB Registration of Auditors of Non-Public Broker-Dealers Frequently Asked Questions" (Question 5), available at www.sec.gov/divisions/marketreg/faq-pcaobregbdauditors.htm.

Q4. If my firm becomes registered with the Board, what ongoing obligations will it have to the PCAOB?

A4. Board rules currently pending with the SEC would require all registered firms, including those that do not audit issuers, to comply with the PCAOB's annual and special reporting requirements. Once those rules are effective, you will have to file with the Board an annual report, providing basic information about your firm. You will also have to file a special report if certain, specified events occur. These rules, once effective, will also require firms to pay an annual fee. The amount of that fee has not yet been announced. You can read a full description of the annual and special reporting rules adopted by the Board in PCAOB Release No. 2008-004 at http://pcaobus.org/Rules/Rulemaking/Pages/Docket019.aspx.

In any given year, both the requirement to file an annual report and the requirement to pay an annual fee apply only to firms that are registered as of March 31 of that year. Firms that become registered after March 31 of a given year would not file an annual report or pay an annual fee that year.

A firm's failure to comply with the reporting and fee requirements, as well as a failure to comply with the requirements to provide complete and accurate information in the application process, could result in disciplinary sanctions, potentially including revocation of a firm's registration.

Mechanics of Registration

Q5. How does my firm submit a registration application?

A5. Registration applications are electronic and can only be obtained by accessing the Board's secure registration system. To gain access to the registration system, go to the Registration page of the Board's website (www.pcaobus.org/Registration) and click on "Register with the PCAOB" in the gray box on the right. You will be presented with a log-in box and instructions to establish a user ID and password by submitting an "Online Entitlement Request Form." Follow the instructions to establish a user ID and password, and

return to this log-in page to access PCAOB's secure registration system, where you may download the PDF version of the Form 1 registration application. (Note: The registration system also offers the option to submit Form 1 using XML. See Board FAQ #3.for further information on this option). Complete the application on your computer, making sure to take careful note of the name and location of the file containing your application.

To submit the registration application, log back into the registration system and follow the instructions to upload your completed Form 1. After Form 1 is uploaded, the system will calculate your firm's registration fee and present you with an invoice. You will be given a link to a site where you can submit your payment electronically. Once you've paid, your application will be deemed submitted.

Q6. How long will it take my firm to get registered?

A6. The Board has up to 45 days after the date your firm submits its application to take action on the application. The actual number of days until approval will vary depending on the information contained in the application and the number of applications that are pending at the same time as your firm's application. However, if the Board requests additional information concerning the application, a new 45-day period will begin when the additional information is received. In addition, if the Board cannot determine whether it is in the public interest to approve a firm's application, the Board may hold a hearing. While the applicant could elect to treat the hearing notice as a denial, if it does not do so, it will have waived the 45-day requirement for Board action. See Board FAQ #14 for additional information concerning notices of hearing.

Content of the Registration Application

Q7. My firm does not participate in audits of issuers. Are there sections of the registration application we can skip?

A7. Before responding to any item in the registration application, an applicant should give careful attention to the definitions of terms used in the item. Of particular significance in this context are the definitions of "issuer" (which does not include a non-public broker-dealer), "audit" and "audit report" (which are limited to work and reports relating to the financial statements of issuers), and "associated person" of the applicant (which encompasses only persons that perform work in connection with an audit of an issuer).

If your firm did not, in the current calendar year or in the year preceding submission of its application, participate at all in the audit of an issuer, and your firm does not expect to do so in the current calendar year, it will have no information responsive to Part II (Listing of Applicant's Public Company Audit Clients and Related Fees) or to Item 7.1 (Listing of Accountants Associated with Applicants), and may not have information responsive to other items on the application. The form contains "NA" boxes that you should check to indicate that particular parts of the form do not apply to your firm. A firm that certifies financial statements of broker-dealers, however, should, when filling out an application, also bear in mind the answer to question no. 9 below.

Before concluding that it does not participate in audits of issuers, an applicant should understand that audit work performed for a non-public entity could nevertheless constitute participation in an audit of an issuer if that work is used by another firm in connection with the other firm's audit of an issuer, such as a parent company. In that circumstance, applicants should carefully consider whether they have played, or expect in the current calendar year to

play, a "substantial role" in the audit of an issuer as that defined term is used in the registration application.

Q8. Part IV of the registration application requires my firm to provide a statement of its quality control policies. How detailed should we be in describing our quality control policies?

A8. Your firm's discussion of quality control policies should be a summary description presented in a clear, concise and understandable format. You should not provide us with your entire internal quality control manual, but should prepare a brief document that provides an overview of your firm's policies with respect to independence, integrity and objectivity; engagement performance; personnel management; acceptance and continuance of clients and engagements; and monitoring.

Q9. Should my firm provide any specific information relevant to its work for broker-dealers?

A9. In light of the expiration of the SEC order, the staff believes that certain specific information may be relevant to the Board's consideration of an application. In order to avoid the Board seeking the information through a formal request for additional information, which could delay Board action on the application until 45 days after all requested additional information is submitted, the staff urges all applicants who have certified financial statements for SEC filings by broker-dealer clients in the two-year period preceding submission of the application and who intend to continue to do so to (a) indicate that fact in the "Applicant Profile" section on the first page of Form 1 by checking the box for item number 2, and (b) provide the following information:

> 1. Broker-dealer clients: Include in Exhibit 4.1, in addition to a description of the firm's quality control policies, a separate file listing (a) all broker-dealers for which the firm certified financial statements in the current or preceding calendar year, including the business address of each broker-dealer and, as to each, the dates of any such certification by the firm; and (b) any additional broker-dealers for which the firm expects to certify financial statements in the current calendar year, including the business address of each.
>
> 2. Individuals' disciplinary histories: Include in Exhibit 5.3 a statement indicating whether any proprietor, partner, principal, shareholder, or officer of the firm, or any accountant employed by the firm who participates in the firm's work relating to certification of broker-dealer financial statements, has a history that meets any of the criteria described in Item 5.1.a. of Form 1. If any of those individuals has such a history, provide as to each matter the information described in Item 5.1.b. of Form 1. In considering the criteria described in Item 5.1.a.1., please give careful attention to Board FAQ #33.

Q10. Are registration applications made public? If so, can my firm protect any of the information it provides in the application from public disclosure?

A10. The Board makes registration applications available to the public by posting them to its web site as soon as practicable after approving or disapproving them. If your firm wishes to protect information in its registration application from public disclosure, it may request confidential treatment for that information by checking the box labeled "CR" that appears in the application relating to the exact item of information that you want to be treated confidentially. Your firm will be notified of the Board's determination with respect to your request after the Board has acted on your application.

For each request for confidential treatment, your firm must attach, as exhibit 99.1, an explanation as to why you believe the information should be

treated confidentially. Refer to Board Rule 2300 (http://pcaobus.org/Rules/PCAOBRules/Pages/Section_2.aspx) for the test the Board will apply in considering whether to grant your requests.

Requesting confidential treatment of a portion of a text exhibit to Form 1 requires your firm to submit two versions of the exhibit – one version should contain all the information in the exhibit and the other version should redact those portions of the exhibit as to which the firm is seeking confidential treatment and show with a notation each redaction that has been made.

Further Questions About Registration

Q11. What should I do if I have further questions?

A11. If you have questions, you should first review the Board's FAQs on Registration, the Board's rules and Instructions to Form 1, and the Instructions for filling out Form 1 that are available for download after you log in to the registration system. If you still have questions, you can email the PCAOB's registration staff at registration-help@pcaobus.org, or call the registration staff's help line at (202) 207-9329. The hours of operation for the help line are 9 a.m. to 5 p.m. EDT, Monday through Friday.

.07 STAFF QUESTIONS AND ANSWERS

References to Authoritative Accounting Guidance in PCAOB Standards

September 2, 2009

Summary:

Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff questions and answers regarding descriptions of and references to authoritative accounting guidance contained in the standards of the PCAOB were prepared by the Office of the Chief Auditor. Additional questions should be directed to Barbara Vanich, Associate Chief Auditor (202/207-9363; vanichb@pcaobus.org) or Greg Scates, Deputy Chief Auditor (202/207-9114; scatesg@pcaobus.org).

FASB Accounting Standards Codification

On June 30, 2009, the Financial Accounting Standards Board ("FASB") issued FASB Statement of Financial Accounting Standards No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162* ("FAS 168"). That standard establishes the FASB Codification ("Codification") as the source of authoritative non-Commission accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with U.S. generally accepted accounting principles ("U.S. GAAP").[1] The Codification is effective for financial statements issued for interim and annual periods ending after September 15, 2009.

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Descriptions of and References to U.S. GAAP

Q1. Certain PCAOB standards include descriptions of and references to U.S. GAAP and accounting requirements. What is the status of those descriptions of and references to U.S. GAAP and accounting requirements upon the effective date of the Codification?

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[1] See U.S. Securities and Exchange Commission ("SEC" or "Commission") Release Nos. 33-9062A; 34-60519A; FR-80A, *Commission Guidance Regarding the Financial Accounting Standards Board's Accounting Standards Codification* (August 19, 2009).

A1. Certain PCAOB standards contain descriptions of and references to U.S. GAAP that existed prior to the Codification. Those descriptions and references were not intended to represent and do not represent authoritative sources of U.S. GAAP.

Some PCAOB standards include descriptions of and references to accounting requirements that are no longer current. Further, some PCAOB standards include descriptions of accounting requirements that may not represent the final language as adopted in the Codification.

The accounting standards set by the FASB are recognized by the U.S. Securities and Exchange Commission ("SEC" or "Commission") as generally accepted under Section 108 of the Sarbanes-Oxley Act of 2002.[2] Therefore, auditors should disregard descriptions of and references to accounting requirements in PCAOB standards that are inconsistent with the Codification.

Auditors should look to the relevant sections of the Codification and to SEC requirements to identify the applicable accounting and reporting requirements for the company under audit. The FASB's web site contains a cross-reference search function to assist users in transitioning to the Codification.[3]

The PCAOB plans to revise these descriptions and references in its future standards-setting projects.

Auditor's Responsibilities Regarding the Codification

Q2. What is the auditor's responsibility if, in using the Codification, the auditor believes that an item in the financial statements should be accounted for differently under the Codification than under pre-Codification U.S. GAAP?

A2. The FASB has stated that, generally, the Codification does not represent a change in U.S. GAAP. The FASB, however, has acknowledged that through the process of drafting the Codification, certain wording changes might theoretically lead an issuer to conclude differently on an accounting matter.[4] To address those types of changes, the FASB will continue to accept feedback on Codification content after the effective date to improve content and address unintentional changes, when applicable.[5] The FASB also has acknowledged that in reviewing the Codification issuers might discover guidance of which they were previously unaware that now indicates that an error may exist in previously issued financial statements.[6]

If an issuer reaches a different conclusion on an accounting matter, an auditor should evaluate management's conclusion on whether the different accounting treatment is a change in an accounting principle or an error, following the guidance in Codification Topic 250, Accounting Changes and Error Corrections.[7]

If the different accounting treatment is a change in an accounting principle, the auditor should follow the direction in:

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[2] See SEC Release Nos. 33-8221; 34-47743, *Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter* (April 25, 2003).

[3] The Codification cross-reference table is available at: http://asc.fasb.org/crossref&analyticsAssetName=home_page_crossreference.

[4] See FAS 168, paragraph A15.

[5] Ibid., paragraph A17.

[6] Ibid., paragraph A16.

[7] This Codification topic was formerly referred to as FAS 154, *Accounting Changes and Error Corrections*.

- AU sec. 508, *Reports on Audited Financial Statements*
- PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*

If the different accounting treatment is an error, the auditor should follow the direction in:

- AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*
- AU sec. 508, *Reports on Audited Financial Statements*
- PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*
- PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, on evaluating deficiencies in an integrated audit, and AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*, on evaluating deficiencies in an audit of financial statements only.

Q3. What are the other responsibilities of an auditor with respect to the Codification?

A3. Auditors will need to become knowledgeable about using the Codification. Additionally, for reviews of interim financial information and audits of financial statements for periods ending after September 15, 2009, when referencing or including an excerpt from U.S. GAAP in audit documentation, the relevant Codification topic is the appropriate source for that reference or excerpt. It may be desirable, but is not necessary, to update certain existing audit documentation (e.g., audit schedules, memoranda) containing previous references to U.S. GAAP prepared prior to the Codification.

Audits of Financial Statements Prepared in Conformity with International Financial Reporting Standards

Q4. What consideration, if any, should an auditor give to descriptions of and references to U.S. GAAP in the standards of the PCAOB if he or she is auditing the financial statements of a foreign private issuer ("FPI")[8] prepared in conformity with International Financial Reporting Standards ("IFRS"),[9] as issued by the International Accounting Standards Board?

A4. In an audit of an FPI's financial statements that are prepared in conformity with IFRS, the auditor needs to consider SEC requirements and IFRS to determine the applicable accounting and reporting requirements and should disregard descriptions of and references to U.S. GAAP in PCAOB standards.

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[8] See Rule 3b-4(c) of the Securities Exchange Act of 1934 for the definition of "foreign private issuer."

[9] See Form 20-F, General Instruction E(c), and items 17 and 18; 17 C.F.R. 249.220f; and SEC Release Nos. 33-8879; 34-57026; International Series Release No. 1306; File No. S7-13-07 (December 21, 2007).

.08 STAFF QUESTIONS AND ANSWERS

Special Reporting on Form 3

January 12, 2010

Summary:

The questions and answers below set out staff guidance to assist registered public accounting firms with respect to the requirement to file with the Public Company Accounting Oversight Board ("PCAOB" or "Board") special reports on Form 3. This guidance does not constitute Board rules, nor has it been approved by the Board.

The questions and answers below were prepared by the PCAOB staff to supplement PCAOB Release No. 2008-004, *Rules on Periodic Reporting by Registered Public Accounting Firms* (June 10, 2008) and the instructions to Form 3, which can be found at http://pcaobus.org/Rules/Rulemaking/Docket019/2008-06-10_Release_No_2008-004.pdf. Please note that the instructions to Form 3 include various "notes" intended to address anticipated questions.

Overview of the Requirements Relating to Special Reporting on Form 3

Q1. What is the general nature of the obligation to file special reports on Form 3?

A1. The PCAOB's reporting framework includes two types of reporting obligations. Each registered firm must provide basic information once a year, covering a 12-month period that ends March 31, by filing an annual report on Form 2. Separately, there are certain events ("Form 3 events") that, if they occur, a firm must report on Form 3 within specified time frames. The reportable events described on Form 3 are not events that routinely occur, and some firms might never experience an event required to be reported on Form 3.

Q2. Does the requirement to file special reports on Form 3 apply to all registered firms, regardless of the nature of the firm's practice?

A2. Yes. Each firm that is registered with the PCAOB, regardless of the reason the firm is registered, regardless of whether the firm is required to be registered, and regardless of whether the firm plays any role in audits of issuers, must comply with the requirement to file special reports on Form 3 if any of the reportable events described in Form 3 occur with respect to the firm.

Q3. What are the time frames within which events must be reported on Form 3?

A3. The deadlines for filing special reports on Form 3 are set out in Rule 2203(a). In general, any Form 3 event that occurs while a firm is registered must be reported on Form 3 within 30 days after the event occurs. There are, however, two special situations involving one-time reporting deadlines for firms to "bring current" certain information that was submitted on a firm's registration application.

The first situation relates to firms that are registered as of December 31, 2009, when Rule 2203(a) took effect. For those firms, a specified subset of Form 3 events must be reported if they occurred before December 31, 2009 and information concerning them continues to be current as of December 31, 2009. This reporting requirement is described in detail in General Instruction No. 4 to Form 3. Any firm registered as of December 31, 2009 should review General Instruction No. 4 to determine whether it has any "bring current" reporting obligation, and any such report must be filed on Form 3 by February 1, 2010.

The second situation relates to firms that become registered after December 31, 2009. For those firms, any Form 3 events that occur between the cut-off date used by the firm for purposes of providing information on its registration application and the date the firm receives notice of approval of its application for registration must be reported on Form 3 within 30 days of receiving notice of approval of the application. With respect to events that occur while a firm's registration application is pending, however, firms should also take account of Q&A 18 in the Board's Frequently Asked Questions Regarding Registration with the Board (PCAOB Release 2003-011C), which encourages applicants to notify the staff in writing if information contained in the application changes in any significant way while the application is pending.

Q4. What are the consequences of failing to file a special report after a Form 3 event occurs, or of a late filing?

A4. The failure to file a timely special report after a Form 3 event occurs is a violation of PCAOB Rule 2203(a). As with any violation of PCAOB rules, a registered firm that violates Rule 2203(a), and any associated person who causes that violation, could be subject to disciplinary proceedings and disciplinary sanctions, which, in appropriate circumstances, could include revoking a firm's registration and barring an individual from being an associated person of a registered firm.

In addition, the annual report on Form 2 that every firm must file, for each 12-month period ending March 31, requires the firm to certify that it filed all required special reports on Form 3 with respect to events that occurred during that 12-month reporting period. If a firm overlooked the special reporting requirements for some period of time, the firm would eventually discover that it needed to become current on its Form 3 obligations, even if that meant late filing of a Form 3, so that it could provide the certification required in order to satisfy the annual reporting requirement.

Q5. What happens if the firm does not know of the Form 3 event within 30 days of its occurrence?

A5. The reportable events in Form 3 are described in a way such that either the firm would necessarily be in a position to know about them as they occur (*e.g.*, the firm has changed its name) or that the event triggering the reporting obligation is the firm *becoming aware* of certain information. With respect to that latter category of events, the instructions to Form 3 specify that the firm is deemed to have become aware of the relevant facts on the date that any partner, shareholder, principal, owner, or member of the firm first becomes aware of the facts. The Board's release adopting the special reporting requirements noted that it is reasonable to expect a firm to have controls designed to ensure that any such person who becomes aware of relevant facts understands the firm's reporting obligation and brings the matter to the attention of persons responsible for compliance with the obligation.

Q6. If a firm has requested leave to withdraw from registration by filing Form 1-WD, and that request is pending with the Board, must the firm continue to comply with the requirement to file special reports on Form 3?

A6. No. PCAOB Rule 2107(c) provides that the obligation to file special reports on Form 3 is suspended for any firm that has pending before the Board a Form 1-WD requesting leave to withdraw from registration. In the event that the firm decides to withdraw a pending Form 1-WD, PCAOB Rule 2107(f) requires that the firm file any special report that the firm would have been required to file had the Form 1-WD not been pending.

Events Required to be Reported on Form 3

Q7. What events are required to be reported on Form 3?

A7. The events that must be reported on Form 3 are described in Part II (and the instructions to Part II) of Form 3. For quick reference, a single page summary of the categories of reportable events is set out at the end of this document, but firms should refer to the more detailed descriptions in Part II of Form 3 for the specific events that must be reported. Firms should not attempt to report via Form 3 any events that are not described in Part II of Form 3. For example, while firms must report certain categories of legal proceedings involving the firm or certain firm personnel, firms are not required to report *all* legal proceedings involving the firm or its personnel, and firms should not attempt to use Form 3 to report proceedings not described in Part II of Form 3.

In reviewing the descriptions of events that must be reported, firms should bear in mind that some terms used in those descriptions are defined, for these purposes, in ways that may differ from a firm's common usage of the terms. Defined terms used in Form 3 are italicized, and the definitions can be found in PCAOB Rule 1001 or by clicking on an italicized term in the online form.

Q8. One of the reportable events on Form 3 is a firm's withdrawal of a previously issued audit report. Must a firm file Form 3 in every case where the firm withdraws an audit report or withdraws its consent to the use of its name by an issuer?

A8. No. If the issuer in question complies with its obligation to disclose the matter pursuant to Item 4.02 of a Form 8-K filed with the Securities and Exchange Commission, the firm need not, and should not, separately report the matter on Form 3. However, in the event the issuer fails to make the required Form 8-K filing within the time required by the Commission's rules, the firm must report that event on Form 3 within 30 days after that Form 8-K filing deadline, unless, within that 30-day period, the issuer reports the matter on a late-filed Form 8-K.

Q9. Reportable events on Form 3 include a firm entering into certain relationships with persons or entities who are currently the subject of specified PCAOB sanctions or Securities and Exchange Commission orders. Does a firm need to report such a relationship even if the person or entity does not participate in audits of issuers?

A9. Yes. Those relationships must be reported on Form 3 regardless of whether the relevant person or entity participates in audits of issuers.

Q10. Reportable relationships referred to in the preceding question include certain relationships with entities that are currently the subject of a PCAOB sanction disapproving the entity's application for registration. What does it mean to be "currently the subject" of such a sanction?

A10. An entity is considered to be "currently the subject" of a Board sanction disapproving registration if either of the following is true: (1) the Board order disapproving registration identified a date after which the Board would

not treat the violations described in the order as a sole basis for possible disapproval of a new registration application, and that date has not passed, or (2) the Board order identifies no such date, and the entity has not subsequently become registered with the Board.

Q11. For purposes of Form 3's reporting requirements, is a person or entity considered to be "currently the subject of" a specified PCAOB sanction if the sanction has not yet taken effect because it is pending review by the Securities and Exchange Commission?

A11. A person or entity is not "currently the subject of" a PCAOB sanction if the imposition of the sanction has been stayed, pursuant to Section 105(e) of the Act, by virtue of an application to the Commission for review, and the stay has not been lifted.

Q12. The obligation to report new relationships with persons or entities currently the subject of certain PCAOB sanctions and Commission orders is not by its terms limited to situations in which the firm has become aware of such sanctions or orders. What if the firm is not aware of them?

A12. The sanctions and orders that give rise to this reporting obligation are public information. A firm generally should be able to identify this information as to any person or entity with whom or which it enters into a new relationship, even if the person or entity is not forthcoming about it.

Q13. One of the reportable events on Form 3 is a change in a registered firm's name. Should a firm file a report on Form 3 to report all name changes, including those that occur in connection with a merger or other change in the firm's legal form?

A13. No. A change in a firm's name should be reported on Form 3 if, and only if, other than the name change, the firm remains the same legal entity that it was before the name change. If the name change is in connection with a more significant change in which the firm, as previously constituted, ceases to exist – such as a change in the legal form of the firm or a merger resulting in a new legal entity – the new entity does not automatically succeed to the registration status of the former entity and may not report the event on Form 3 as a mere name change. In that event, the firm should consider whether, pursuant to the provisions of Rule 2108, the firm can make the representations required in a Form 4 filing to enable the firm to succeed to the predecessor firm's registration status.

Q14. If the address of a firm's headquarters changes, must the firm report that change on Form 3?

A14. The only address change that must be reported on Form 3 is a change in the business mailing address (and other contact information) of the person that the firm designates as its primary contact with the PCAOB. If a firm changes its headquarters address, but the contact information for that primary contact person remains unchanged, the firm should not report the headquarters address change on Form 3 but should simply provide the new address in the firm's next annual report on Form 2.

Completing Form 3

Q15. Which portions of Form 3 must be completed if a firm is reporting only a single event?

A15. For any Form 3 filing, a firm must complete Parts I, II, and VIII of Form 3 and at least one of Parts III through VII. Part I identifies the firm

and Part VIII certifies the accuracy of the report. In Part II, the firm must check a box, or boxes, to indicate which of the events described there the firm is reporting. Depending upon which box or boxes the firm checks in Part II, the firm must complete one or more of Parts III through VII to provide certain details.

Q16. May a firm use a single Form 3 filing to report multiple Form 3 events?

A16. A firm may file a Form 3 to report a single event or to report multiple events. Timeliness of reporting, however, is judged with respect to each reported event.

Q17. May a firm combine in a single Form 3 filing the "bring current" reporting described in Q&A 3 above and reporting on other events that occur within the 30-day period before the "bring current" report is due?

A17. Yes, but attention should be given to ensure compliance with the "bring current" reporting requirement. A firm registered as of December 31, 2009 must file a Form 3 by February 1, 2010 to report certain information that is current *as of* December 31, 2009, and it must do so even if that information is superseded by events that occur between December 31, 2009 and February 1, 2010 that must also be reported on Form 3. Similarly, a firm that becomes registered after December 31, 2009 would, within 30 days of becoming registered, need to file a Form 3 to report events that occurred before the date it became registered, even if the relevant information were superseded by other events occurring before the firm filed that "bring current" report. In those situations, a firm would need to file one Form 3 to satisfy the "bring current" obligation and a separate Form 3 to report the subsequent change to that information.

Amending a Previously Filed Form 3

Q18. What should a firm do if it discovers that it provided incorrect information in a filed Form 3 or omitted information that should have been included?

A18. Special reports on Form 3 should be complete and accurate, and an individual in the firm must, on behalf of the firm, certify that the form does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which the statements were made, not misleading. Inaccuracies or omissions could form the basis for disciplinary sanctions for failing to comply with the reporting requirements, and it is therefore in a firm's interest to correct such errors as soon as possible. A firm may do so by filing an amendment pursuant to PCAOB Rule 2205 and the Form 3 instructions specific to amendments.

Q19. Should a firm amend a previously filed Form 3 to update previously reported information that has changed since the original filing?

A19. Amendments are appropriate only to correct information that was incorrect at the time of the filing, or to supply omitted information that should have been supplied at the time of the filing. The amendment process should not be used to update information reported on a Form 3. In the event of changes, the firm should consider whether a new Form 3 reporting obligation has been triggered.

Requesting Confidential Treatment

Q20. How does a firm request confidential treatment for information that it provides on Form 3?

A20. A firm may request confidential treatment for information provided in certain, though not all, items in Form 3. General Instruction No. 8 to Form 3 identifies the items with respect to which a firm may request confidential treatment. In filling out the form, the firm may request confidential treatment by checking the "CR" box associated with each such item for which the firm wants to request confidential treatment.

The requirements concerning what a firm must submit in support of a request for confidential treatment have changed effective December 31, 2009 and so, for most firms, are different than they were when the firm submitted its registration application. As amended, PCAOB Rule 2300(c) requires both a representation that the information has not otherwise been publicly disclosed and either (1) a detailed explanation of the grounds on which the information is considered proprietary, or (2) a detailed explanation of the basis for asserting that the information is protected by law from public disclosure and a copy of the specific provision of law.

A special report on Form 3 will be published on the PCAOB Web site promptly upon submission. That public version of the Form will not display information for which confidential treatment is requested unless and until a determination to deny the request becomes final. As a safeguard, as a firm prepares to submit a completed Form 3 to the PCAOB's Web-based system, the system allows a firm to view two separate versions of the completed form – one showing all of the information the firm has entered and the other showing what the publicly available version of the form will look like, with redactions where confidential treatment is requested. Before finally submitting the form, the firm should carefully review the redacted version to make sure that the firm has requested confidential treatment where it intended to do so.

Withholding Information on the Basis of Non-U.S. Legal Restrictions

Q21. May a firm refrain from reporting information on Form 3 if non-U.S. law prohibits the firm from providing or obtaining the information, just as the PCAOB allows firms to withhold information from Form 1 registration applications on that basis?

A21. A non-U.S. firm may withhold certain information from a required special report on Form 3 because of non-U.S. legal restrictions, but the related process, which is governed by PCAOB Rule 2207, is significantly different from the process in the context of a registration application on Form 1.

A legal conflict can be asserted on Form 3 only if the firm is actually withholding information that the form requires. A separate section at the end of each relevant part of Form 3 instructs the firm that if any portion of its response in that part is incomplete because of an asserted legal conflict, the firm must, in that separate section, identify the specific items with respect to which the firm actually has withheld, or been precluded from obtaining, responsive information.

Also, unlike the case with Form 1, the materials that a firm must compile in support of its position that a conflict exists – a copy of the relevant provisions of law, a legal opinion, and a written explanation of the firm's efforts to seek consents or waivers that would overcome the conflict – need not routinely be submitted when the firm files Form 3. Rather, the firm must certify on Form 3 that it has those materials in its possession, and it must submit them only in the event of a follow-up request from the Board or the Director of the Division of Registration and Inspections.

Q22. To comply with the requirement to have a legal opinion relevant to the asserted conflict of law, must a firm secure a new legal opinion specific to each Form 3 that the firm files?

A22. The supporting materials maintained by the firm need only contain a legal opinion that the firm has reason to believe is current with respect to the relevant point of law. Rule 2207 does not attempt to specify the ways in which a firm may satisfy this requirement, and various approaches might be satisfactory. Compliance does, however, depend upon a firm implementing in good faith some mechanism for generally being aware of relevant changes in the law, rather than relying on a particular legal opinion in perpetuity without genuine regard for whether the law changes.

Q23. If a non-U.S. firm takes the position that non-U.S. law prohibits it from providing any of the details required by Parts III through VII of Form 3 with respect to a particular matter, is the firm still required to file a Form 3 concerning that matter?

A23. Yes. The firm must still file a Form 3 completing Parts I, II, and VIII, and checking the relevant boxes in Parts III through VII to indicate the items as to which information is being withheld.

The Mechanics of Reporting Through the PCAOB Web-Based System

Q24. How does a firm submit Form 3 to the Board?

A24. To submit Form 3, your firm will need to access the PCAOB's Registration, Annual and Special Reporting system at https://rasr.pcaobus.org/Security/Login.aspx. Your firm will need to provide the Username and Password issued in connection with the registration process to gain access. Registered firms may email registration-help@pcoabus.org for assistance with log-in information. Firms that are already registered with the Board should not request a new user name and password through the Board's web site—this functionality is for firms seeking to register with the Board and is not appropriate for registered firms needing login assistance.

Q25. What formats will the system accept? What software is needed to properly prepare and submit Form 3?

A25. To properly communicate with the Board's system, you will need Internet Explorer 6.0 or later, or Firefox 2.0 or later. To complete Form 3, you may fill it out online as a web form, or you may submit it in XML, which is a computer language. If you have large amounts of information going into Form 3, you may find that XML is a more convenient way to submit the data because you would be able to load the data into your XML file directly or indirectly from other databases. If you would like to make your submission in XML, you must download the XML Schema from the Board's system. Using XML will likely require the assistance of a programmer who is versed in that computer language.

Form 3 may require you to submit various documents to be labeled as exhibits. The system will accept exhibits in PDF, GIF or JPEG format. You can convert text documents or scan documents for submission, as long as they are submitted in PDF, GIF or JPEG.

Q26. Is assistance available on how to create a web form in the Board's system?

A26. You may view an online tutorial on how to create a web form in the Board's system by going to the Registration, Annual and Special Reporting page of the Board's web site (http://pcaobus.org/Registration/Pages/SampleForms.aspx) and viewing the system tutorial entitled "Create a Form."

Further Questions About Reporting on Form 3

Q27. What should I do if I have further questions?

A27. If you have questions, you should first review the Board's release adopting the reporting requirements, including the rules and Instructions to Form 3, which can be found at http://pcaobus.org/Rules/Rulemaking/Docket019/2008-06-10_Release_No_2008-004.pdf, and the instructions for filling out Form 3 that are available for download after you log into the registration and reporting system. The instructions to Form 3 include various notes intended to address anticipated questions. If you still have questions, you can email the PCAOB's registration staff at registration-help@pcaobus.org.

Summary of Form 3 Reportable Events

- The firm has withdrawn an audit report on financial statements, and the issuer failed to comply with Commission reporting requirements (Item 4.02 of Commission Form 8-K) concerning the matter.
- With respect to the 100 issuer audit client threshold that determines the frequency of Board inspections under Rule 4003, the firm has crossed to a different side of the threshold than the firm was on in the preceding calendar year.
- The firm, or a partner, shareholder, principal, owner, member, or audit manager of the firm (in some cases limited to those who provided at least ten hours of audit services for any issuer during the firm's current or most recently completed fiscal year), has become a defendant in certain types of criminal proceedings, or any such proceeding has been concluded as to the firm or the individual.
- The firm, or a partner, shareholder, principal, owner, member, or audit manager of the firm (in some cases limited to those who provided at least ten hours of audit services for any issuer during the firm's current or most recently completed fiscal year), has become a defendant or respondent in a government-initiated civil proceeding, or an administrative or disciplinary proceeding (other than a Board proceeding), arising out of conduct in the course of providing professional services, or any such proceeding has been concluded as to the firm or the individual.
- The firm, or a parent or subsidiary, has become the subject of a petition filed in bankruptcy court or certain similar proceedings.
- The firm has taken on individuals or entities meeting certain criteria regarding disciplinary history, or entered into an arrangement to receive from such individuals or entities services related to the firm's audit practice or related to services the firm provides to issuer audit clients.

- The firm has obtained or lost authorization to engage in the business of accounting or auditing in a particular jurisdiction, or that authorization has become subject to conditions or contingencies.
- Contact information for the firm's Board contact person has changed.
- The firm has changed its legal name, while otherwise remaining the same legal entity that it was before the name change.

.09 STAFF QUESTIONS AND ANSWERS

Succession to Registration Status—Form 4

January 12, 2010

Summary:

The questions and answers below set out staff guidance to assist registered public accounting firms with respect to succeeding to a predecessor firm's registration status with the Public Company Accounting Oversight Board ("PCAOB" or "Board") by filing Form 4. This guidance does not constitute Board rules, nor has it been approved by the Board.

The questions and answers below were prepared by the PCAOB staff to supplement PCAOB Release No. 2008-005, *Rules on Succeeding to the Registration Status of a Predecessor Firm* (July 29, 2008) and the instructions to Form 4, which can be found at http://pcaobus.org/Rules/Rulemaking/Docket020/2008-07-29_Release_No_2008-005.pdf. Please note that the instructions to Form 4 include various "notes" intended to address anticipated questions.

Q1. What is Form 4?

A1. In the circumstances in which it is available, the Form 4 succession process allows an unregistered firm to succeed to the PCAOB registration status of a predecessor firm that was registered without any interruption in the registration status. Under certain circumstances, however, that registration status may only be temporary, as discussed in Q&A 9 below.

Q2. What are the circumstances in which a firm can succeed to a predecessor's registration status by filing Form 4?

A2. The Form 4 succession process is available (1) if there has been a change in a registered firm's form of organization, or the registered firm has changed the jurisdiction under the law of which it is organized; or (2) if a registered firm is acquired by an unregistered firm, or combines with any other entity or entities, including other registered firms, to form a new public accounting firm. Form 4 can be used only in those circumstances and only if the firm seeking to succeed to registration status makes certain representations required in the form. In the absence of those conditions, a firm cannot use Form 4 to succeed to the registration status of a predecessor and would need to file a registration application on Form 1 if it wished to seek registration.

Q3. Is a firm that results from the circumstances described in Q&A 2 above required to file Form 4?

A3. A firm that results from the circumstances described in Q&A 2 above should not assume that it is registered with the PCAOB just because a predecessor firm was registered with the PCAOB. If the firm wishes to be registered with the PCAOB, Form 4 provides an optional route to registration, but the firm is not required to use the Form 4 process and can choose, instead, to file an application for registration on Form 1.

Q4. Can or should Form 4 be filed in circumstances in which a registered firm has acquired another firm?

A4. If a registered firm acquires another firm in such a way that the acquiring registered firm continues to exist as the same legal entity, that firm continues to be registered and need not, and cannot, file Form 4. The acquiring registered firm would, however, need to report the acquisition when it files its annual report on Form 2 for the period in which the acquisition occurred.

Q5. By when must Form 4 be filed to be timely?

A5. PCAOB Rule 2109(a) governs the timeliness of Form 4 filings. With respect to changes or combinations that take effect on or after December 31, 2009 (the effective date of Rule 2109), a Form 4, to be timely, must be filed within 14 days after the change or combination takes effect.

Q6. If a firm resulted from circumstances described in Q&A 2 above that occurred after a predecessor firm became registered but before December 31, 2009, can and should the firm file a Form 4 to succeed to the predecessor's registration status? If so, when must the form be filed to be timely?

A6. Form 4 can be filed with respect to changes or combinations that took effect before December 31, 2009, and should be filed if the firm intends to operate, and believes it has been operating, under the registration status of the predecessor. For firms in that situation, Form 4 must be filed by January 14, 2010 to be timely. *Even if a firm in that situation has previously informally reported the change or combination to the PCAOB staff and provided requested representations, the firm still would need to file Form 4 to succeed to the predecessor's registration status.*

Q7. If a firm files Form 4 to succeed to the registration status of a registered firm, how soon will it be deemed to have succeeded to the predecessor's registration status?

A7. If a firm files a timely Form 4, succession to the predecessor's registration status is automatic. As discussed below, however, in some cases that registration status may only be temporary.

Q8. If a firm can make the representations required by Form 4 but has failed to file a timely Form 4, is it still possible for the firm to succeed to a predecessor's registration status?

A8. Under PCAOB Rule 2108(d), a firm that is in a position to file Form 4 but has failed to do so timely may submit a completed Form 4 along with a request for leave to file the form out of time. The submission must be accompanied by an exhibit describing the reasons the form was not timely filed and a statement of the grounds on which the firm asserts that the Board should grant leave to file the form out of time. The Board will evaluate the request in light of the relevant facts and circumstances and the public interest and may, in its discretion, grant or deny the request.

During the period that a request for leave to file out of time is pending with the Board, a firm should not assume that it is a registered public accounting firm. A Board decision to grant the request would effectively confer registered status on the firm back to the date of the transaction that is the subject of the Form 4 filing (just as with a timely filed Form 4), but a Board decision to deny the request would mean that the firm was not registered during that period.

Q9. In what circumstances would a firm's succession to the registration status of a predecessor firm through Form 4 be only temporary?

A9. If the event giving rise to the Form 4 filing is an unregistered firm's acquisition of a registered firm or a combination of firms into a new firm, the firm must address three yes-or-no questions, set out in Item 3.2.e. If the firm answers yes to any one of those questions or, in the case of a non-U.S. firm,

declines to answer any one of those questions on the ground that non-U.S. law prevents it from doing so, the firm can succeed to the predecessor's registration status, but only temporarily. In that situation, to succeed temporarily, the firm must also represent that it either has filed an application for registration on Form 1 or will do so no later than 45 days after the date of the acquisition or combination giving rise to the Form 4 filing.

Q10. How long does temporary succession to registration last?

A10. In general, temporary registration ceases to be effective on the earlier of the 91st day after the effective date of the acquisition or combination as reported on Form 4 or the date on which the Board approves a Form 1 registration application submitted by the firm. Temporary registration can be extended in certain circumstances, as described in PCAOB Rule 2108(b)(2)(iii)-(iv).

Q11. A firm seeking to file a Form 4 would, necessarily, be an unregistered firm. How does such a firm access the PCAOB's Web-based system to be able to file the form?

A11. In every situation in which a Form 4 can be filed, there is necessarily at least one firm involved that was a registered firm before the change or combination that gives rise to the Form 4 filing. The firm that seeks to file a Form 4 must identify that firm (or one of those firms) on Form 4 as the predecessor firm to whose registration status the firm is succeeding. The firm should access the PCAOB system using that firm's user ID and password.

Q12. Should the predecessor registered firm, to whose registration status the firm is succeeding, file Form 1-WD to withdraw from registration?

A12. No, the firm designated in Form 4 as the predecessor must not withdraw from registration.

Q13. In the event that a combination of firms giving rise to a Form 4 filing involves any registered firms other than the firm designated in Form 4 as the predecessor, should those other firms file Form 1-WD to withdraw from registration?

A13. Yes, any such firms should file Form 1-WD seeking to withdraw from registration, and the firm filing Form 4 must represent that each such registered firm has done so.

Q14. What should a firm do if it discovers that it provided incorrect information in a filed Form 4 or omitted information that should have been included?

A14. Form 4 filings should be complete and accurate, and an individual in the firm must, on behalf of the firm, certify that the form does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which the statements were made, not misleading. Inaccuracies or omissions could form the basis for disciplinary sanctions for failing to comply with the rules and instructions relating to Form 4, and it is therefore in a firm's interest to correct such errors as soon as possible. A firm may do so by filing an amendment pursuant to PCAOB Rule 2205 (which applies to Form 4 through PCAOB Rule 2109(d)) and the Form 4 instructions specific to amendments.

Q15. If a Form 4 as filed appears on its face to be timely, but a subsequent amendment reveals that the original filing was in fact untimely, what is the firm's registration status?

A15. In that circumstance, the original Form 4 filing would be voided and its effect would be null. If the firm still wanted to try to succeed to the predecessor's registration status, it would need to submit a new Form 4 and request leave to file out of time.

Q16. Can a firm make changes to a Form 4 that has been submitted with a request for leave to file out of time and is pending in that status?

A16. In that circumstance, a firm can withdraw the pending submission and replace it with a new submission. A note to General Instruction No. 7 of Form 4 describes the process.

Q17. Once a firm has filed a timely Form 4, or the Board has granted leave to file a Form 4 out of time, should any subsequent changes to information that was provided on the Form 4 be submitted through an amendment to the Form 4?

A17. No. Amendments are appropriate only to correct information that was incorrect at the time of the filing, or to supply omitted information that should have been supplied at the time of the filing. The amendment process should not be used to update information that has changed since the Form 4 was filed. To the extent, however, that the subsequent changes are events that are required to be reported on a special report on Form 3, the firm should report them on Form 3 in accordance with Rule 2203.

Q18. Can a firm request confidential treatment for information on Form 4?

A18. A firm may request confidential treatment for certain limited aspects of a Form 4 filing, which are identified in General Instruction No. 9 to Form 4. Confidential treatment requests are not automatically granted. The requirements concerning what a firm must submit in support of a confidential treatment request have changed effective December 31, 2009 and so, for most firms, are different than they were when the firm submitted its registration application. As amended, PCAOB Rule 2300(c) requires both a representation that the information has not otherwise been publicly disclosed and either (1) a detailed explanation of the grounds on which the information is considered proprietary, or (2) a detailed explanation of the basis for asserting that the information is protected by law from public disclosure and a copy of the specific provision of law.

Q19. May a firm refrain from providing information on Form 4 if non-U.S. law prohibits the firm from providing or obtaining the information?

A19. If a non-U.S. firm complies with the requirements of PCAOB Rule 2207 (which applies to Form 4 through PCAOB Rule 2109(d)) and the relevant instructions to Form 4, it may withhold certain limited information because of asserted non-U.S. legal restrictions and still succeed to a predecessor's registration status. PCAOB Rules nevertheless reserve to the Board the right to subsequently require the information. In addition, while a non-U.S. firm may withhold answers to the yes-or-no questions discussed in Q&A 9 on the basis of a non-U.S. legal restriction, doing so will result in succession to registration being temporary only, and the firm would need to file a registration application on Form 1 to seek registration beyond the period of the temporary registration.

Q20. Does the Form 4 process affect any aspect of Securities and Exchange Commission Rules or Commission staff guidance concerning the consequences of mergers or similar transactions involving accounting firms?

A20. No. The Form 4 process has no affect on such matters; it merely allows the new entity to be registered with the PCAOB.

Q21. What should I do if I have further questions?

A21. If you have questions, you should first review the Board's release adopting the reporting requirements, including the rules and Instructions to Form 4, which can be found at http://pcaobus.org/Rules/Rulemaking/

Docket020/2008-07-29_Release_No_2008-005.pdf, and the instructions for filling out Form 4 that are available for download after you log into the registration and reporting system. The instructions to Form 4 include various notes intended to address anticipated questions. If you still have questions, you can email the PCAOB's registration staff at registration-help@pcaobus.org.

.10 STAFF QUESTIONS AND ANSWERS

Auditing Standard No. 7, Engagement Quality Review

February 19, 2010

Summary:

Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff question and answer related to Auditing Standard No. 7, *Engagement Quality Review* was prepared by the Office of the Chief Auditor. Additional questions should be directed to Dima Andriyenko, Associate Chief Auditor (202/207-9130; andriyenkod@pcaobus.org) or Greg Scates, Deputy Chief Auditor (202/207-9114; scatesg@pcaobus.org).

Auditing Standard No. 7

On January 15, 2010, the U.S. Securities and Exchange Commission ("SEC") approved Auditing Standard No. 7, *Engagement Quality Review* ("AS No. 7,"), which was adopted by the PCAOB on July 28, 2009.[1] AS No. 7 supersedes the Board's interim standard,[2] applies equally to all registered firms,[3] and requires an engagement quality review ("EQR") and concurring approval of issuance for each audit engagement and for each engagement to review interim financial information conducted pursuant to the standards of the PCAOB.[4]

In its order approving AS No. 7, the SEC encouraged the PCAOB to provide further implementation guidance on the documentation requirements of the standard in light of comments the SEC received during its comment period. The following staff question and answer provides implementation guidance.

Documentation of an EQR

Q. Page 21 of the adopting release provides the following example of the application of the standard's documentation requirements:

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[1] See SEC Release No. 34-61363 (Jan. 15, 2010); PCAOB Release 2009-004, *Auditing Standard No. 7, Engagement Quality Review and Conforming Amendment to the Board's Interim Quality Control Standards* (Jul. 28, 2009) (the "adopting release").

[2] Requirements of Membership of the Securities and Exchange Commission Practice Section ("SECPS") of the American Institute of Certified Public Accountants ("AICPA") Section 1000.08(f).

[3] The Board's interim standard applied only to registered firms that were members of the SECPS as of April 16, 2003.

[4] See paragraph 1 of AS No. 7.

> [I]f a reviewer identified a significant engagement deficiency to be addressed by the engagement team, the engagement team should document its response to the identified deficiency in accordance with [Auditing Standard No. 3, *Audit Documentation*]. Because AS No. 7 does not require duplication of documentation prepared by the engagement team, the engagement quality reviewer does not have to separately document the engagement team's response. Rather, the EQR documentation should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand, e.g., the significant deficiency identified, how the reviewer communicated the deficiency to the engagement team, why such matter was important, and how the reviewer evaluated the engagement team's response.

Does this example suggest that the standard requires documentation of all of the interactions between the engagement quality reviewer and the engagement team, including all of the interactions before a matter is identified as a significant engagement deficiency?

A. No. The example in the adopting release illustrates how the documentation requirements of AS No. 7 should be applied once a reviewer concludes that a significant engagement deficiency exists.

Paragraph 19 of AS No. 7 establishes a requirement[5] that "[d]ocumentation of an engagement quality review should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of this standard...."

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[5] Specific documentation requirements are also set forth at Paragraph 19a-c.

Section 200
[Reserved]

Section 300
STAFF VIEWS

.01 An Audit of Internal Control That Is Integrated With an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies

January 23, 2009

Introduction

The information in this publication is intended to help auditors apply the provisions of the Public Company Accounting Oversight Board's ("PCAOB" or "Board") 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"),[1] to audits of smaller, less complex public companies ("smaller, less complex companies"). If used appropriately, it can help auditors design and execute audit strategies that will achieve the objectives of Auditing Standard No. 5. This publication is not, however, a rule of the Board and does not establish new requirements. All audits of internal control over financial reporting—regardless of the size of the company—must comply with the requirements of Auditing Standard No. 5. Also, this publication does not address all of the requirements and direction in Auditing Standard No. 5 or all issues that may be encountered in audits of smaller, less complex companies.

In adopting Auditing Standard No. 5, one of the Board's objectives was to make the audit of management's assessment of the effectiveness of internal control over financial reporting ("audit of internal control") more clearly scalable for smaller, less complex companies. Thus, the standard contains direction to auditors on scaling the audit based on a company's size and complexity. This publication discusses how that direction may be applied to audits of smaller, less complex companies, including smaller companies that are not complex, and how auditors may address some of the challenges that might arise in audits of those companies.

Development of This Publication

This publication was developed by the staff of the Board's Office of the Chief Auditor ("OCA"). To develop the information in this publication, OCA organized a working group composed of auditors who have experience with audits of internal control over financial reporting in smaller, less complex companies. These auditors identified issues that pose particular challenges in auditing internal control in smaller, less complex companies. The auditors provided insights and examples based on their experiences in addressing these issues, and

[1] PCAOB Release 2007-005A, "Auditing Standard No. 5 – *An Audit Of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Independence Rule and Conforming Amendments*" (June 12, 2007).

they assisted in drafting a preliminary version of the guidance. In developing that preliminary guidance, OCA also consulted with financial executives from smaller public companies, who helped the staff evaluate whether it appropriately reflected the smaller, less complex company environment.

The staff issued the preliminary guidance for public comment on October 17, 2007, and received 23 comments. After considering those comments, the staff made certain changes in this final version that clarify or enhance the guidance. Appendix B to this publication discusses comments received and related changes.

References

This publication assumes that the user is familiar with the provisions of Auditing Standard No. 5 and the following publications:

- Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), *Internal Control—Integrated Framework*[2]
- COSO, *Internal Control over Financial Reporting—Guidance for Smaller Public Companies* (June 2006) ("COSO Small Companies Guidance")
- SEC Release No. 33-8810, Commission Guidance Regarding *Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934* (June 20, 2007) ("SEC Management Guidance")

The following publications also provide information that might be relevant to the audit of internal control over financial reporting:

- SEC Release No. 33-8809, *Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting* (June 20, 2007)
- SEC Release No. 33-8829, *Definition of the Term Significant Deficiency* (August 3, 2007)
- SEC Release No. 33-8238, *Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports* (June 5, 2003)
- SEC Office of the Chief Accountant, Division of Corporation Finance, *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports: Frequently Asked Questions* (September 24, 2007)

Internal Control Examples in this Publication

This publication discusses certain types of controls and provides examples of those controls to help auditors understand the types of controls that might be encountered in the audit of a smaller, less complex company and to provide a context for the discussion of audit strategies for evaluating the effectiveness

[2] Auditing Standard No. 5 states that the auditor should use the same internal control framework that management uses in its assessment of internal control. Although this publication uses certain terms and concepts from COSO's *Internal Control—Integrated Framework*, the principles in this publication could be applied to other internal control frameworks.

of those controls. The discussions and examples of controls do not establish internal control requirements and are not intended as guidance to management regarding establishing or evaluating internal control over financial reporting.

Chapter 1

Scaling the Audit for Smaller, Less Complex Companies

Auditing Standard No. 5 establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of internal control over financial reporting that is integrated with an audit of the financial statements.

The complexity of a company is an important factor in the auditor's risk assessment and determination of the necessary audit procedures. Auditing Standard No. 5 provides direction on scaling the audit of internal control based on the size and complexity of a company. Scaling is important for audits of internal control of all companies, especially smaller, less complex companies. This chapter highlights principles for scaling the audit of internal control over financial reporting set forth in Auditing Standard No. 5 and discusses considerations for applying the principles in audits of smaller, less complex companies.

The audit of internal control should be integrated with the audit of the financial statements, so the auditor must plan and perform the work to achieve the objectives of both audits.[1] This direction applies to all aspects of the audit, and it is particularly relevant to tests of controls. This chapter discusses testing of controls in an integrated audit of a smaller, less complex company. Appendix A illustrates an audit approach for the integrated audit.

Scaling the Audit of Internal Control

Scaling the audit of internal control involves tailoring the audit approach to fit the individual facts and circumstances of the company. Many smaller companies have less complex operations, and they typically share many of the following attributes:

- 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
- Fewer levels of management, each with a wide span of control.[2]

The attributes of a smaller, less complex company can affect the particular risks that could result in material misstatement of the company's financial statements and the controls that a company might establish to address those risks. Consequently, these attributes have a pervasive effect on the audit of internal control, including assessing risk, determining significant accounts and disclosures and relevant assertions, selecting controls to test, and testing the design and operating effectiveness of controls. The following are examples of internal control-related matters that might be particularly affected by the attributes of a smaller, less complex company—

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[1] See Auditing Standard No. 5, paragraphs 6 and 7.

[2] See Auditing Standard No. 5, paragraph 9.

- *Use of entity-level controls to achieve control objectives.* In smaller, less complex companies, senior management often is involved in many day-today business activities and performs duties that are important to effective internal control over financial reporting. Consequently, the auditor's evaluation of entity-level controls can provide a substantial amount of evidence about the effectiveness of internal control over financial reporting. Chapter 2 discusses methods of evaluating entity-level controls and explains how that evaluation can affect the testing of other controls.
- *Risk of management override.* The extensive involvement of senior management in day-to-day activities and fewer levels of management can provide additional opportunities for management to override controls or intentionally misstate the financial statements in smaller, less complex companies. In an integrated audit, the auditor should consider the risk of management override and company actions to address that risk in connection with assessing the risk of material misstatement due to fraud and evaluating entity-level controls.[3] Chapter 3 discusses these considerations in more detail.
- *Implementation of segregation of duties and alternative controls.* By their nature, smaller, less complex companies have fewer employees, which limits the opportunity to segregate incompatible duties. Smaller, less complex companies might use alternative approaches to achieve the objectives of segregation of duties, and the auditor should evaluate whether those alternative controls achieve the control objectives.[4] This is discussed in Chapter 4.
- *Use of information technology (IT).* A smaller, less complex company with less complex business processes and centralized accounting operations might have less complex information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the testing of IT general controls might focus on those controls that are important to the effective operation of the selected application controls. Chapter 5 discusses IT controls in more detail.
- *Maintenance of financial reporting competencies.* Smaller, less complex companies might address their needs for financial reporting competencies through means other than internal staffing, such as engaging outside professionals. The auditor may take into consideration the use of those third parties when assessing competencies of the company. Chapter 6 discusses the evaluation of financial reporting competencies in more detail.
- *Nature and extent of documentation.* A smaller, less complex company typically needs less formal documentation to run the business, including maintaining effective internal control over financial reporting. The auditor may take that into account when selecting controls to test and planning tests of controls. Chapter 7 discusses this in more detail.

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[3] See Auditing Standard No. 5, paragraphs 14 and 24.

[4] See Auditing Standard No. 5, paragraph 42.

In some audits of internal control, auditors might encounter companies with numerous or pervasive control deficiencies. Smaller, less complex companies can be particularly affected by ineffective entity-level controls, as these companies typically have fewer employees and fewer process-level controls. The auditor's strategy can be influenced by the nature of the control deficiencies and factors such as the availability of audit evidence and the effect of the deficiencies on other controls. Chapter 8 discusses these situations in more detail.

Tests of Controls in an Integrated Audit

Auditing Standard No. 5 provides direction on selecting controls to test and testing controls in an audit of internal control. The standard also provides direction on testing controls for the audit of the financial statements. The following paragraphs discuss how the auditor might apply the directions in Auditing Standard No. 5 to an audit of a smaller, less complex company.

Selection of Controls to Test

Appropriate selection of controls helps focus the auditor's testing on those controls that are important to the auditor's conclusion about whether the company's internal control over financial reporting is effective. The decision about whether to select a control for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of misstatement in a given relevant assertion rather than on how the control is labeled (e.g., entity-level control, transaction-level control, control activity, monitoring control, preventive control, or detective control). A practical starting point for identifying these controls is to consider the controls that management relies on to achieve its objectives for reliable financial reporting.

Besides the overriding consideration of whether a control addresses the risk of misstatement, as a practical matter, the auditor might also consider the following factors when selecting controls to test:

- Is the control likely to be effective?
- What evidence exists regarding operation of the control?

When selecting controls to test, the auditor could seek to select controls that are more likely to be effective in addressing the risk of misstatement in one or more relevant assertions.[5] If none of the controls that are intended to address a risk for a relevant assertion is likely to be effective, the auditor can take that into account in determining the evidence needed to support a conclusion about the effectiveness of controls for this assertion.[6] Chapter 8 discusses in more detail how auditors could design their audit strategies in a situation when internal control over financial reporting is likely to be ineffective because of the presence of pervasive control deficiencies that result in one or more material weaknesses.

The auditor needs to be able to obtain enough evidence about a control's operation to conclude on its effectiveness. The auditor could take into account the nature and availability of audit evidence when selecting controls to test and determining the nature, timing, and extent of tests of controls. For example, if

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[5] There might be more than one control that addresses the assessed risk of misstatement for a particular relevant assertion; conversely, one control might address the assessed risk of misstatement to more than one relevant assertion. It is neither necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective. See Auditing Standard No. 5, paragraph 40.

[6] Auditing Standard No. 5, paragraph 47, indicates that, generally, less evidence is needed to support a conclusion that controls are not operating effectively.

two or more controls adequately address the risk of misstatement for a relevant assertion, the auditor may select the control for which evidence of operating effectiveness can be obtained more readily. Chapter 7 discusses documentation and audit evidence in more detail.

Tests of Operating Effectiveness of Controls

Historically, the approach for financial statement audits of smaller, less complex companies has been to focus primarily on testing accounts and disclosures, with little or no testing of controls. The internal control reporting requirements under Sections 103 and 404 of the Sarbanes-Oxley Act of 2002 (the "Act") give auditors the opportunity to re-consider their traditional approach to the financial statement audit portion of the integrated audit. The principles in Auditing Standard No. 5 also give auditors latitude to determine an appropriate testing strategy to—

(a) Obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end, and

(b) Obtain sufficient evidence to support the auditor's control risk assessments in the audit of the financial statements.[7]

To express an opinion on internal control over financial reporting taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant financial statement assertions. Because the auditor's opinion on internal control over financial reporting is as of a point in time, Auditing Standard No. 5 indicates that he or she should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements.[8]

In an audit of financial statements, the objective of tests of controls is to assess control risk. To assess control risk at less than the maximum, the auditing standards require the auditor to obtain evidence that the relevant controls operated effectively during the entire period upon which the auditor plans to place reliance on those controls.[9] However, the auditor is not required to assess control risk at less than the maximum for all relevant assertions, and, for a variety of reasons, the auditor may choose not to do so.[10]

The auditor's assessment of control risk at the maximum for one or more relevant assertions in an audit of financial statements does not necessarily preclude the auditor from issuing an unqualified opinion in an audit of internal control. The objectives of the two audits are not identical. The auditor could obtain sufficient evidence to support his or her opinion on internal control over financial reporting, even if the auditor decides not to test controls over the entire period of reliance to support a control risk assessment below the maximum. However, if the auditor assesses control risk at the maximum because of identified control deficiencies, the auditor should evaluate the severity of the deficiencies, individually or in combination, to determine whether a material weakness exists.[11]

The auditor's decision about relying on controls in an audit of financial statements may depend on the particular facts and circumstances. In some areas, the auditor might decide to rely on certain controls to reduce the substantive

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[7] See Auditing Standard No. 5, paragraph 7.

[8] See Auditing Standard No. 5, paragraph B2.

[9] See paragraph B4 of Auditing Standard No. 5 and paragraph .66 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*.

[10] See Auditing Standard No. 5, paragraph B4, and AU sec. 319.65.

[11] See Auditing Standard No. 5, paragraph 62.

testing of accounts and disclosures. For other areas, the auditor might perform primarily substantive tests of the assertions without relying on controls. For example, the auditor might test a company's controls over billings and cash receipts processing to cover the entire period of reliance in order to reduce the extent of confirmation of accounts receivable balances but might perform primarily substantive tests of the allowance for doubtful accounts. In this case, the auditor might perform the tests of controls over the allowance for doubtful accounts only as necessary for the audit of internal control over financial reporting.

For some significant accounts, the auditor might decide that a relevant assertion can be tested effectively and efficiently through substantive procedures without relying on controls. For example, the auditor might decide to confirm an outstanding loan payable with the lender rather than rely on controls. In that situation, the auditor may test controls of the relevant assertions only as necessary to support his or her opinion on the company's internal control over financial reporting at year-end.

To obtain evidence about whether a selected control is effective, the control must be tested; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, is one of a number of factors that inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.[12] See the section entitled Specific Responses—Substantive Procedures and Tests of Controls in Appendix A to this publication for more discussion on this topic.

Chapter 2

Evaluating Entity-Level Controls

An important aspect of performing an audit of internal control is the process of identifying and evaluating entity-level controls. This chapter discusses entity-level controls and explains how they can affect the nature, timing, and extent of the auditor's procedures in an audit of internal control for a smaller, less complex company.

For the purposes of this discussion, entity-level controls are controls that have a pervasive effect on a company's internal control. These controls include[1] –

- Controls related to the control environment;
- Controls over management override;
- The company's risk assessment process;
- Centralized processing and controls, including shared service environments;
- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the audit committee[2] and self-assessment programs;[3]

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[12] See Auditing Standard No. 5, paragraphs 47, 58, and B9.

[1] See Auditing Standard No. 5, paragraph 24.

[2] If no audit committee exists, all references to the audit committee in this publication apply to the entire Board of Directors of the company. See 15 U.S.C. 78c(a)58 and 7201(a)(3).

[3] Some smaller, less complex companies might have an internal audit function, especially in regulated industries. If the activities of the internal audit function include controls to monitor other controls, those controls also are entity-level controls.

- Controls over the period-end financial reporting process; and
- Policies that address significant business control and risk management practices.

In smaller, less complex companies, senior management often is involved in many day-to-day business activities and performs many controls—including entity-level controls—that are important to effective internal control over financial reporting. When this is the case, the auditor's evaluation of entity-level controls can be an important source of evidence about the effectiveness of internal control over financial reporting.

Effective controls related to the control environment and controls that address the risk of management override are particularly important to the effective functioning of controls performed by senior management. Chapter 3 discusses the auditor's evaluation of the risk of management override and mitigating actions.

Auditors might find that limited formal documentation is available regarding the operation of some entity-level controls. Chapter 7 discusses how the auditor can obtain evidence about controls when less formal documentation is available.

Evaluation of Entity-Level Controls and Testing of Other Controls

Auditing Standard No. 5 requires the auditor to test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting. This includes evaluating the company's control environment and period-end financial reporting process.[4]

Identifying Entity-Level Controls

The process of identifying relevant entity-level controls could begin with discussions between the auditor and appropriate management personnel for the purpose of obtaining a preliminary understanding of each component of internal control over financial reporting (i.e., control environment, risk assessment, control activities, monitoring, and information and communication).

While evaluating entity-level controls, auditors might identify controls that are capable of preventing or detecting misstatements in the financial statements. The period-end financial reporting process and management's monitoring of the results of operations are potential sources of such controls.

Assessing the Precision of Entity-Level Controls

Auditing Standard No. 5 indicates that entity-level controls vary in nature and precision—

- Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.
- Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lowerlevel controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that

[4] See Auditing Standard No. 5, paragraph 22, and 25–27.

misstatements to a relevant assertion will be prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls. [See Example 2-1.]

- Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.[5] [See Example 2-2.]

As noted previously, the key consideration in assessing the level of precision is whether the control is designed in a manner to prevent or detect on a timely basis misstatements in one or more assertions that could cause the financial statements to be materially misstated and whether such control is operating effectively.[6] Factors that auditors might consider when judging the level of precision of an entity-level control include the following:

- *Purpose of the control*. A procedure that functions to prevent or detect misstatements generally is more precise than a procedure that merely identifies and explains differences.
- *Level of aggregation*. A control that is performed at a more granular level generally is more precise than one performed at a higher level. For example, an analysis of revenue by location or product line normally is more precise than an analysis of total company revenue.
- *Consistency of performance*. A control that is performed routinely and consistently generally is more precise than one performed sporadically.
- *Correlation to relevant assertions*. A control that is indirectly related to an assertion normally is less likely to prevent or detect misstatements in the assertion than a control that is directly related to an assertion.
- *Criteria for investigation*. For detective controls, the threshold for investigating deviations or differences from expectations relative to materiality is an indication of a control's precision. For example, a control that investigates items that are near the threshold for financial statement materiality has less precision and a greater risk of failing to prevent or detect misstatements that could be material than a control with a lower threshold for investigation.
- *Predictability of expectations*. Some entity-level controls are designed to detect misstatements by using key performance indicators or other information to develop expectations about reported amounts. The precision of those controls depends on the ability to develop sufficiently precise expectations to highlight potentially material misstatements.

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[5] See Auditing Standard No. 5, paragraph 23.

[6] The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatement of the financial statements. The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control has the necessary authority and competence to perform the control effectively. See Auditing Standard No. 5, paragraphs 42 and 44.

When forming an opinion on the effectiveness of a company's internal control over financial reporting, the auditor should evaluate evidence obtained from all sources, including misstatements detected during the financial statement audit.[7] Evidence regarding detected misstatements also might be relevant in assessing the level of precision of entity-level controls.

Effect of Entity-Level Controls on Testing of Other Controls

The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise might have performed on other controls. For example, if the auditor has designed an audit approach with an expectation that certain entity-level controls (e.g., controls in the control environment) will be effective and those controls are not effective, the auditor might re-evaluate the planned audit approach and decide to expand his or her audit procedures.

On the other hand, the auditor's evaluation of some entity-level controls can result in a reduction of his or her testing of other controls, such as controls over corresponding relevant assertions. The degree to which the auditor might be able to reduce testing of controls over relevant assertions in such cases depends on the precision of the entity-level controls.

Example 2-1—Monitoring the Effectiveness of Other Controls

Scenario: A small public video game developer conducts business in the United States and other countries, requiring the company to maintain a multitude of bank accounts. A staff accountant is charged with performing bank reconciliations for the accounts according to a predetermined schedule (some of the accounts have a different closing date). Through inquiries of management, the auditor learns that the company's chief financial officer ("CFO"), who is an experienced accountant, reviews on a monthly basis the bank reconciliations prepared by the staff accountant as a means to determine—

- whether reconciliations are being prepared on a timely basis,
- the nature of reconciling items identified through the process, and
- whether reconciling items are investigated and resolved on a timely basis.

Audit Approach: In this example, the purpose of the control is one of the factors that the auditor considers in assessing precision of the CFO's review. The auditor has noted that the purpose of the CFO's review is to check that the staff has performed the reconciliations as described above. Therefore, the auditor does not expect the CFO's review of the reconciliations to be sufficiently precise to detect misstatements by itself. However, the CFO's review could still influence the auditor's assessment of risk because it provides additional information about the nature and consistency of the reconciliation procedures. The auditor obtains evidence about the CFO's review through inquiry and document inspection, evaluates the review's effectiveness, and determines the amount of direct testing of the reconciliation controls that is needed based on the assessed level of risk. If the auditor concludes that the CFO's review is effective, she could reduce the direct testing of the reconciliation controls, absent other indications of risk.

[7] See Auditing Standard No. 5, paragraph 71.

Example 2-2—Entity-Level Controls Related to Payroll Processing

Scenario: A manufacturer of alternative fuel products and systems for the transportation market has union labor, supervisors, managers, and executives. All plants run two shifts six days a week, with each having approximately the same number of employees.

The chief financial officer ("CFO") has been with the company for 10 years and thoroughly understands its business processes, including the payroll process, and reviews weekly payroll summary reports prepared by the centralized accounting function. With the company's flat organizational design and smaller size, the CFO's background with the company and his understanding of the seasons, cycles, and workflows, and close familiarity with the budget and reporting processes, the CFO quickly identifies any sign of improprieties with payroll and their underlying cause—whether related to a particular project, overtime, hiring, layoffs, and so forth. The CFO investigates as needed to determine whether misstatements have occurred and whether any internal control has not operated effectively, and takes corrective action.[8] Based on the results of audit procedures relating to the control environment and controls over management override, the auditor observes that the CFO demonstrates integrity and a commitment to effective internal control over financial reporting.

Audit Approach: The auditor evaluates the effectiveness of the CFO's reviews, including the precision of those reviews. She inquires about the CFO's review process and obtains other evidence of the review. She notes that the CFO's threshold for investigating significant differences from expectations is adequate to detect misstatements that could cause the financial statements to be materially misstated. She selects some significant differences from expectations that were flagged by the CFO and determines that the CFO appropriately investigated the differences to determine whether the differences were caused by misstatements. Also, in considering evidence obtained throughout the audit, the auditor observes that the results of the financial statement audit procedures did not identify likely misstatements in payroll expense.

The auditor decides that the reviews could detect misstatements related to payroll processing because the CFO's threshold for investigating significant differences from expectations is adequate. However, she determines that the control depends on reports produced by the company's IT system, so the CFO's review can be effective only if controls over the completeness and accuracy of those reports are effective.

After performing the tests of the relevant computer controls, the auditor concludes that the review performed by the CFO, when coupled with relevant controls over the reports, meets the control objectives for the relevant aspects of payroll processing described above. (See Chapter 5 for a discussion of tests of controls over such reports.)

[8] Adapted from the COSO Small Companies Guidance, Volume II: Guidance, page 90.

Chapter 3

Assessing the Risk of Management Override and Evaluating Mitigating Actions

The risk of management override of controls exists in all organizations, but the extensive involvement of senior management in day-to-day activities and fewer levels of management can provide additional opportunities for management to override controls in smaller, less complex companies. Company actions to mitigate the risk of management override are important to the consideration of the effectiveness of internal control over financial reporting.

In an integrated audit, the auditor should consider the risk of management override in connection with assessing the risk of material misstatement due to fraud, as he or she evaluates mitigating actions in connection with the evaluation of entity-level controls and selecting other controls to test.[1] This chapter discusses the auditor's consideration of the risk of management override of internal control and evaluation of actions that companies take to mitigate that risk.

Assessing the Risk of Management Override

AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to assess the risk of material misstatement due to fraud ("fraud risk"). As part of that assessment, the auditor is directed to perform the following procedures to obtain information to be used in identifying fraud risks, which includes procedures to assess the risk of management override[2]—

- *Conducting an engagement team discussion regarding fraud risks.* This discussion includes brainstorming about how and where management could override controls to engage in or conceal fraudulent financial reporting.
- *Making inquiries of management, the audit committee, and others in the company to obtain their views about the risks of fraud and how those risks are addressed.* These inquiries can provide information about the possibility of management override of controls.
- *Considering fraud risk factors.* Fraud risk factors include events or conditions that indicate incentives and pressures for management to override controls, opportunities for management override, and attitudes or rationalizations that enable management to justify override of controls.

After identifying fraud risks, the auditor should assess those risks, taking into account an evaluation of the company's programs and controls that are intended to address those risks.[3]

Because of the characteristics of fraud, the auditor's exercise of professional skepticism is particularly important when considering the risk of material misstatement due to fraud, including the risk of management override of controls.

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[1] See Auditing Standard No. 5, paragraph 14.

[2] See AU sec. 316.14–.34.

[3] See AU sec. 316.43–45.

Evaluating Mitigating Controls

Auditing Standard No. 5 directs the auditor to evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls as part of the evaluation of entity-level controls.[4]

Smaller, less complex companies can take a number of actions to address the risk of management override. The following are examples of some of the controls that might address the risk of management override—

- Maintaining integrity and ethical values;
- Active oversight by the audit committee;
- Maintaining a whistleblower program; and
- Controls over certain journal entries.

When assessing a company's anti-fraud programs and controls, the auditor should evaluate whether the company has appropriately addressed the risk of management override.[5] Often, a combination of actions might be implemented to address the risk of management override.

Evaluating Integrity and Ethical Values

An important part of an effective control environment is sound integrity and ethical values, particularly of top management, which are communicated and practiced throughout the company. A code of conduct or ethics policy is one way that a company can communicate its policies with respect to ethical behavior. This type of control can be effective if employees are aware of the company's policies and observe the policies in practice.

Auditors should evaluate integrity and ethical values as part of the assessment of the control environment component of internal control.[6] One approach for testing the effectiveness of the company's communications regarding integrity and ethical values is to gain an understanding of what the company believes it is communicating to employees and interview employees to determine if they are aware of the existence of the company's policies for ethical behavior and what they understand those policies to be. A discussion with employees regarding observed behaviors can assist the auditor further in understanding management's past actions and determining whether management's behavior demonstrates and enforces the principles in its code of conduct. The auditor's experience with the company also can be an important source of information about whether management demonstrates integrity and ethical values in its business practices and supports the achievement of effective internal control in its day-to-day activities.

Evaluating Audit Committee Oversight

An active and independent audit committee evaluates the risk of management override, including identifying areas in which management override of internal control could occur, and assesses whether those risks are appropriately addressed within the company. As part of their oversight duties, the audit committee might perform duties such as meeting with management to discuss

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[4] See Auditing Standard No. 5, paragraph 14.

[5] See Auditing Standard No. 5, paragraphs 14 and 24.

[6] See Auditing Standard No. 5, paragraph 25.

significant accounting estimates and reviewing the reasonableness of significant assumptions and judgments.[7]

The consideration of the effectiveness of the audit committee's oversight is part of the evaluation of the control environment. In connection with the auditor's inquiries of the audit committee, required by AU sec. 316.22, the auditor may interview audit committee members to determine their level of involvement and their activities regarding the risk of management override. For example, the auditor might read minutes of audit committee discussions on matters related to the committee's oversight or might observe some of those discussions if the auditor attends the meetings in connection with the audit. In addition, the auditor can examine evidence of the board of directors' or audit committee's activities that address the risk of management override, such as monitoring of certain transactions.

Evaluating Whistleblower Programs

A whistleblower program provides an outlet for employees or others to report behaviors that might have violated company policies and procedures, including management override of controls. A key aspect of an effective whistleblower program is the appropriateness of responses to concerns expressed by employees through the program. The audit committee may review reports of significant matters and consider the need for corrective actions.[8]

Audit procedures relating to a whistleblower program are intended to assess whether the program is appropriately designed, implemented, monitored, and maintained. Such procedures might include inquiry of employees, inspection of communications to employees about the program, and, if tips or complaints have been received, follow-up procedures to evaluate whether remedial actions were taken as necessary.

Evaluating Controls over Journal Entries

Controls that prevent or detect unauthorized journal entries can reduce the opportunity for the quarterly and annual financial statements to be intentionally misstated. Such controls might include, among other things, restricting access to the general ledger system, requiring dual authorizations for manual entries, or performing periodic reviews of journal entries to identify unauthorized entries.

As part of obtaining an understanding of the financial reporting process, the auditor should consider how journal entries are recorded in the general ledger and whether the company has controls that would either prevent unauthorized journal entries from being made to the general ledger or directly to the financial statements or detect unauthorized entries.[9] Tests of controls over journal

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[7] When a company does not have an audit committee, the entire board of directors is considered the audit committee under Section 2(b)(3) of the Act. In such circumstances, Principle 2, *Board of Directors* of COSO Small Companies Guidance states, "[w]hen a board chooses not to have an audit committee, the full board performing the activities described should have a sufficient number of independent members."

[8] Section 10A(m)(4) of the Securities Exchange Act of 1934 requires audit committees to "establish procedures for (A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters." The SEC has implemented this provision by adopting rules directing the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by the Act.

[9] See Auditing Standard No. 5, paragraphs 26 and 34; AU sec. 316.58–.60.

entries could be performed in connection with the testing of journal entries required by AU sec. 316.

Considering the Effects of Other Evidence

The auditor might identify indications of management override in other phases of the integrated audit. For example, AU sec. 316 requires the auditor to perform procedures in response to the risk of management override, including examining journal entries for evidence of fraud, reviewing accounting estimates for bias, and evaluating the business rationale for significant, unusual transactions.[10] Also, if the auditor performs walkthroughs during the audit of internal control,[11] he or she could obtain information about potential management override by asking employees about their knowledge of override. Also, the auditor might identify indications of management override when evaluating the results of tests of controls or other audit procedures.

If the auditor identifies indications of management override of controls, he or she should take such indications into account when evaluating the risk of override and the effectiveness of mitigating actions.[12]

Example 3-1—Audit Committee Oversight

Scenario: The audit committee of a small utility company discusses in executive session at least annually its assessment of the risks of management override of internal control, including motivations for management override and how those activities could be concealed. The audit committee performs the following procedures to address the risk of management override: (a) reviews the reasonableness of management's assumptions and judgments used to develop significant estimates; and (b) reviews the functioning of the company's whistleblower process and related reports, and from time to time, inquires of managers not directly responsible for financial reporting (including personnel in sales, procurement, and human resources, among others), obtaining information regarding concerns about ethics or indications of management override of internal controls.[13]

Audit approach: In this situation, the auditor can draw upon several sources of evidence to evaluate the audit committee's oversight. The auditor might attend selected meetings of the audit committee where the risks of override and whistleblower programs are discussed or review minutes of meetings where those matters are discussed. In connection with its inquiries of the audit committee about the risk of fraud, as required by AU sec. 316, the auditor can discuss matters relating to the risk of override, including how the audit committee assesses the risk of management override, what information, if any, the audit committee has obtained about possible management override, and how the audit committee's concerns about the risk of management override have been addressed. This information can inform the auditor's consideration of the risk of management override and the testing of mitigating controls.

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[10] See AU sec. 316.57–.66.

[11] Auditing Standard No. 5, paragraph 34, sets forth the objectives that should be achieved to further understand likely sources of misstatement and as part of selecting controls to test. The standard states that performing walkthroughs will frequently be the most effective way to achieve the objectives in paragraph 34. Paragraphs 37–38 of Auditing Standard No. 5 provide direction on walkthroughs.

[12] See Auditing Standard No. 5, paragraph 15.

[13] Adapted from the COSO Small Companies Guidance, Volume II: Guidance, page 26.

Chapter 4

Evaluating Segregation of Duties and Alternative Controls

Segregation of duties refers to dividing incompatible functions among different people to reduce the risk that a potential material misstatement of the financial statements would occur without being prevented or detected. Assigning different people responsibility for authorizing transactions, recording transactions, reconciling information, and maintaining custody of assets reduces the opportunity for any one employee to conceal errors or perpetrate fraud in the normal course of his or her duties.[1]

When a person performs two or more incompatible duties, the effectiveness of some controls might be impaired. For example, reconciliation procedures may not effectively meet the control objectives if they are performed by someone who also has responsibilities for transaction recording or asset custody.

Smaller, Less Complex Companies' Approach to Segregation of Duties

By their nature, smaller, less complex companies have fewer employees, which limits their opportunities to implement segregation of duties. Due to these personnel restrictions, smaller, less complex companies might approach the control objectives relevant to segregation of duties in a different manner from larger, more complex companies. Despite personnel limitations, some smaller, less complex companies might still divide incompatible functions by using the services of external parties. Other smaller, less complex companies might implement alternative controls intended to achieve the same objectives as segregation of duties for certain processes.

This chapter discusses the auditor's evaluation of the company's approach to achieving the objectives of segregation of duties at a smaller, less complex company.

Audit Strategy Considerations

It is generally beneficial for the auditor and the company to identify concerns related to segregation of duties early in the audit process to allow the auditor to design procedures that effectively respond to those concerns. Also, management might have already identified, as part of its risk assessment, risks relating to inadequate segregation of duties and alternative controls that respond to those risks. Where walkthroughs are performed, those procedures can help identify matters related to segregation of duties.

When management implements an alternative control or combination of controls that address the same objectives as segregation of duties, the auditor should evaluate whether the alternative control or controls effectively meet the related control objectives.[2] The auditor's approach to evaluating those alternative control or controls depends on the control objectives, the nature of the controls, and the associated risks. The following sections of this chapter

[1] See the COSO Small Companies Guidance, Volume II: Guidance, page 5, for discussion of management's actions relevant to segregation of duties issues.

[2] See Auditing Standard No. 5, paragraph 42.

discuss how the auditor can evaluate common approaches to the objectives of segregation of duties.

Use of External Resources

Some small companies use external parties to assist with some of their financial reporting-related functions. Use of external parties also can help achieve segregation of certain incompatible duties without investing in additional full-time resources.

A company might use one or more types of external-party arrangements in meeting its control objectives. Consultants, other professionals, or temporary employees can assist companies in performing some controls or other duties. For more complex or specialized portions of internal control, such as cash receipts handling, payroll processing, or securities recordkeeping, the company might use an external party to perform an entire function.

When controls over a relevant assertion depend on the use of an external party to perform a particular function, the auditor could evaluate that function in relation to the company's other relevant controls and procedures. The audit approach used with respect to the externally performed function depends on the circumstances. For those controls that are documented or are observable by the auditor (e.g., controls performed by external professionals at the company's premises), the auditor's evaluation may be similar to what he or she could perform for the company's other controls. For some externally performed functions, the direction relating to use of service organizations may be relevant.[3]

Management Oversight and Review

A smaller, less complex company might address some segregation of duties matters through alternative controls involving management oversight and review activities, e.g., reviewing transactions, checking reconciliations, reviewing transaction reports, or taking periodic asset counts.[4] Many of those types of management activities could be entity-level controls. Chapter 2 discusses the auditor's evaluation of entity-level controls at a smaller, less complex company.[5] Example 4-1 below, and Example 5-1 in Chapter 5 illustrate the testing of certain types of alternative controls.

When the auditor applies a top-down approach to select the controls to test, starting at the financial statement level and evaluating entity-level controls,[6] the auditor might identify entity-level controls that are designed to operate at a level of precision to effectively address the risk of misstatement for one or more relevant assertions. In those cases, the auditor could select and test those entity-level controls rather than test the process controls that could be affected by inadequate segregation of duties.

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[3] See Auditing Standard No. 5, paragraphs B17 – B27, for discussion of the auditor's consideration of a company's use of a service organization in an audit of internal control.

[4] See the COSO Small Companies Guidance, Volume II: Guidance, page 5, for examples of the types of management actions that might be used as alternatives to segregation of duties.

[5] As discussed in Chapter 2, controls related to the control environment and controls over the risk of management override are particularly important to the effective functioning of the controls performed by senior management. Chapter 3 discusses assessing the risk of management override and evaluating mitigating controls.

[6] See Auditing Standard No. 5, paragraph 21.

Example 4-1—Alternative Controls over Inventory

Scenario: A provider of office furnishings and equipment uses a locked storeroom to store certain key components. The person responsible for the components has access to both the storeroom and the related accounting records. To address the risks related to undetected loss of components, the manager responsible for purchasing performs periodic spot-checks of the components and reconciles them to the general ledger in addition to the inventory ledger. The components also are included in the company's year-end inventory count. IT access controls are implemented to prevent the person responsible for the components from entering transactions or modifying related account balances in the general ledger.[7]

Audit approach: The auditor observes the company's year-end inventory counting process. He inspects documentation for some of the periodic spot-checks and the related reconciliations. For discrepancies in the counts or reconciliations inspected, he performs inquiries and inspects the accounting records to determine whether those items were appropriately resolved. Relevant IT access controls are evaluated in connection with the evaluation of IT general controls. (See Chapter 5.)

Chapter 5

Auditing Information Technology Controls in a Less Complex Information Technology Environment

A company's use of information technology (IT) can have a significant effect on the audit of internal control. The IT environment is a consideration in the auditor's risk assessments, selection of controls to test, tests of controls, and other audit procedures.

This chapter discusses the auditor's evaluation of IT controls in a smaller company with a less complex IT environment. It explains how the auditor could decide which IT controls to evaluate and how the auditor could evaluate those controls. In addition, it provides an overview of the major categories of IT controls and related testing considerations for a smaller, less complex IT environment.

Characteristics of Less Complex IT Environments

In smaller companies, less complex IT environments tend to have the following characteristics:

- *Transaction processing*. Data inputs can be readily compared or reconciled to system outputs. Management tends to rely primarily on manual controls over transaction processing.
- *Software*. The company typically uses off-the-shelf packaged software without programming modification. The packaged software requires relatively little user configuration to implement.[1]
- *Systems configurations and security administration*. Computer systems tend to be centralized in a single location, and there are a limited number of interfaces between systems. Access to systems is typically managed by a limited number of personnel.

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[7] Adapted from the COSO Small Companies Guidance, Volume II: Guidance, page 60.

[1] Significant user configuration might create additional risks that require additional controls.

- *End-user computing*. The company is relatively more dependent on spreadsheets and other user-developed applications, which are used to initiate, authorize, record, process, and report the results of business operations, and, in many instances, perform straightforward calculations using relatively simple formulas.

The complexity of the IT environment has a significant effect on the risks of misstatement and the controls implemented to address those risks. The auditor's approach in an environment with the preceding characteristics may be different from the approach in a more complex IT environment.

Some smaller, less complex companies outsource certain of their IT functions to service organizations. Auditing Standard No. 5, paragraphs B17–B27, provides direction on the auditor's consideration of a company's use of a service organization in an audit of internal control.

Determining the Scope of the Evaluation of IT Controls

The following matters affect the scope of the auditor's evaluation of IT controls in a smaller company with a less complex IT environment—

- The risks, i.e., likely sources of misstatement, in the company's IT processes or systems relevant to financial reporting, and the controls that address those risks.[2]
- The reports produced by IT systems that are used by the company for performing important controls over financial reporting.
- The automated controls that the company relies on to maintain effective internal control over financial reporting.

The IT controls that are important to effective internal control over financial reporting generally relate to at least one of the preceding matters, which are discussed in more detail in the following paragraphs. IT control categories and testing procedures are discussed later in this chapter.

IT-Related Risks Affecting Financial Reporting

Paragraph .19 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, lists the following types of IT-related risks that could affect the reliability of financial reporting—

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both;
- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or nonexistent transactions or inaccurate recording of transactions;
- Unauthorized changes to data in master files;
- Unauthorized changes to systems or programs;
- Failure to make necessary changes to systems or programs;
- Inappropriate manual intervention;
- Potential loss of data.

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[2] Auditing Standard No. 5, note to paragraph 36, indicates that the identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to identify significant accounts and disclosures and their relevant assertions, and the controls to test, as well as to assess risk and allocate audit effort as described by the standard.

The IT-related risks that are reasonably possible to result in material misstatement of the financial statements depend on the nature of the IT environment. In a less complex environment, the auditor could identify many of the risks by understanding the software being used and how it is installed and used by the company.

After understanding the relevant IT-related risks, the auditor should identify the controls that address those risks.[3] These controls could include automated controls and IT-dependent controls and the IT general controls that are important to the effective operation of the selected controls. For example, even the simplest IT environments generally rely on controls that are designed to make sure that necessary software updates are appropriately installed, access controls that are designed to prevent unauthorized changes to financial data, and other controls that address potential loss of data necessary for financial statement preparation.

As the complexity of the software or environment increases, the type and number of potential IT risks increase, which could lead the auditor to devote more attention to IT controls.

IT-Dependent Controls

Many controls that smaller, less complex companies rely on are manual controls. Some of those controls are designed to use information in reports generated by IT systems, and the effectiveness of those controls depends on the accuracy and completeness of the information in the reports. When those IT-dependent controls are selected for testing, it also may be necessary to select controls over the completeness and accuracy of the information in the reports in order to address the risk of misstatement. Example 5-1 presents an illustration involving IT-dependent controls.

Other Automated Controls

Although smaller, less complex companies tend to rely primarily on manual controls, they could rely on certain automated controls built into the packaged software to achieve some control objectives. For example, software controls can be used to maintain segregation of duties, prevent certain data input errors, or to help make sure that certain types of transactions are properly recorded. The auditor might focus some of his or her testing on these automated controls and the IT general controls that are important to the effective operation of the automated controls.[4]

Consideration of Deficiencies in General Controls on Tests of Other Controls

IT general controls support operation of the application controls by ensuring the proper access to, and functioning of, the company's IT systems. Deficiencies in the IT general controls may result in deficiencies in the operation of the automated or IT-dependent controls. One of the factors in the auditor's evaluation of the identified deficiencies in the IT general controls, is the interaction of an IT general control and the related automated or IT-dependent controls.[5]

In some situations, an automated or IT-dependent control might be effective even if deficiencies exist in IT general controls. For example, despite the presence of deficient program change controls, the auditor might directly test the related automated or IT-dependent manual control, giving consideration to the

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[3] See Auditing Standard No. 5, paragraph 36.

[4] See Auditing Standard No. 5, paragraph 47.

[5] According to paragraph 65 of Auditing Standard No. 5, one of the risk factors that affects the severity of a deficiency is "The interaction or relationship of the control with other controls, including whether they are interdependent or redundant."

risk associated with the deficient change controls in his or her risk assessment and audit strategy. If the testing results were satisfactory, the auditor could conclude that the automated or IT-dependent manual controls operated effectively at that point in time e.g., as of the issuer's fiscal year end. On the other hand, deficient program change controls might result in unauthorized changes to application controls, in which case the auditor could conclude that the application controls are ineffective.

Example 5-1—IT-Dependent Controls

Scenario: A company has a small finance department. For the accounting processes that have a higher risk of misstatement, senior management performs a number of business process reviews and analyses to detect misstatements in transaction processing.

The company has a small IT department that supports a packaged financial reporting system whose software code cannot be altered by the user. Since the company uses packaged software, and there have been no changes to the system or processes in the past year, the IT general controls relevant to the audit of the internal control over financial reporting are limited to certain access controls and certain computer operation controls related to identification and correction of processing errors. Management uses several system-generated reports in the business performance reviews, but these reports are embedded in the application and programmed by the vendor and cannot be altered.

Audit Approach: The auditor determines that senior management personnel performing the business process reviews and analyses are not involved with incompatible functions or duties that impair their ability to detect misstatements. Based on the auditor's knowledge of the financial reporting system and understanding of the transaction flows affecting the relevant assertions, the auditor selects for testing certain process reviews and analyses and certain controls over the completeness and accuracy of the information in the reports used in management's reviews. The tests of controls could include, for example—

- Evaluating management's review procedures including assessing whether those controls operate at an appropriate level of precision. (See Chapter 2.)
- Evaluating how the company assures itself regarding the completeness and accuracy of the information in the reports used by management in the reviews. Matters that might be relevant to this evaluation include how the company determines that—
  - The data included in the report are accurate and complete. This evaluation might be accomplished through testing controls over the initiation, authorization, processing, and recording of the respective transactions that feed into the report.
  - The relevant computer settings established by the software user are consistent with the objectives of management's review. For example, if management's review is based on items in an exception report, the reliability of the report depends on whether the settings for reporting exceptions are appropriate.

The auditor verifies that the code in the packaged software cannot be changed by the user. The auditor also evaluates the IT general controls that are important to the effective operation of the IT-dependent controls (such as the access controls and operations controls previously described).

Categories of IT Controls

The remaining sections of this chapter discuss major categories of IT controls and considerations for testing them in a smaller, less complex IT environment.

IT General Controls

IT general controls are broad controls over general IT activities, such as security and access, computer operations, and systems development and system changes.

Security and Access

Security and access controls are controls over operating systems, critical applications, supporting databases, and networks that help ensure that access to applications and data is restricted to authorized personnel.

In a small, less complex IT environment, security administration is likely to be centralized, and policies and procedures might be documented informally. A small number of people or a single individual typically supports security administration and monitoring on a part-time basis. Controls for mitigating the risk caused by a lack of segregation of duties over operating systems, data, and applications tend to be detective controls rather than preventive. Access controls tend to be monitored informally.

Tests of security and access controls could include evaluating the general system security settings and password parameters; evaluating the process for adding, deleting, and changing security access; and evaluating the access capabilities of various types of users.

Computer Operations

Computer operations controls relate to day-to-day operations and help ensure that computer operational activities are performed as intended, processing errors are identified and corrected in a timely manner, and continuity of financial reporting data is maintained through effective data backup and recovery procedures.

A smaller, less complex IT environment might not have a formal operations function. There might not be formal policies regarding problem management or data storage and retention, and backup procedures tend to be initiated manually.

Tests of controls over computer operations could include evaluating the backup and recovery processes, reviewing the process of identifying and handling operational problems, and, if applicable, assessing control over job scheduling.

Systems Development and System Changes

Systems development and system change controls are controls over systems selection, design, implementation, and configuration changes that help ensure that new systems are appropriately developed, configured, approved, and migrated into production, and controls over changes—whether to applications, supporting databases, or operating systems—that help to ensure that those changes are properly authorized and approved, tested, and implemented. Although they might be viewed as separate categories, in less complex environments, systems development and system change procedures often are combined for ease of implementation, training, and ongoing maintenance.

A smaller, less complex IT environment typically includes a single or small number of off-the-shelf packaged applications that do not allow for modification of source code. Modifications to software are prepared by and, in some cases,

implemented by, the software vendor in the form of updates or patches or via a network connection between the vendor and the organization. Typically, a small number of individuals or a single individual (employees or consultants) support all development and production activities.

Examples of possible tests of controls over systems development and system changes include examining the processes for selecting, acquiring, and installing new software; evaluating the process for implementing software upgrades or patches; determining whether upgrades and patches are authorized and implemented on a timely basis; and assessing the process for testing new applications and updates.

Application Controls

Application controls are automated or IT-dependent controls intended to help ensure that transactions are properly initiated, authorized, recorded, processed, and reported. For example, in a three-way match process, received vendor invoices are entered into the system, which matches them automatically to the purchase order and goods receipt based on the document reference numbers, price, and quantity. The system's simultaneous matching of the information within the three documents upon their entry to authorize a payment to the vendor is an automated application control. Management's review and reconciliation of an exception report generated by the system is an example of an IT-dependent manual control.[6]

The general nature of application controls tends to be similar in most IT environments, although in less complex environments, the controls tend to be manual and detective rather than automated and preventive. The testing procedures also could be similar. In most IT environments, the auditor could focus on error correction procedures over inputting, authorizing, recording, processing, and reporting of transactions when evaluating application controls. However, in less complex IT environments there might be fewer financial applications affecting relevant assertions and fewer application controls within those applications.

Regardless of the complexity of the IT environment, the audit plan for testing application controls could include a combination of inquiry, observation, document inspection, and re-performance of the controls. Efficiencies can be achieved through altering the nature, timing, and extent of testing procedures performed related to automated and IT-dependent application controls if IT general controls are designed and operating effectively. In some situations, benchmarking of certain automated controls might be an appropriate audit strategy.[7]

End-User Computing Controls

End-user computing refers to a variety of user-based computer applications, including spreadsheets, databases, ad-hoc queries, stand-alone desktop applications, and other user-based applications. These applications might be used as the basis for making journal entries or preparing other financial statement information. End-user computing is especially prevalent in smaller, less complex companies.

End-user computing controls are controls over spreadsheets and other user-developed applications that help ensure that such applications are adequately documented, secured, backed up, and reviewed regularly for process integrity.

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[6] See Example 5-1 for an illustration of how those types of controls might be tested in a small, less complex IT environment.

[7] Auditing Standard No. 5, paragraphs B28–B33, discuss benchmarking of automated controls.

Enduser computing controls include general and application controls over user-developed spreadsheets and applications.

Tests of controls over end-user computing could include assessing access controls to prevent unauthorized access: testing of controls over spreadsheet formulas or logic of queries and scripts; testing of controls over the completeness and accuracy of information reported by the end-user computing applications; and reviewing the procedures for backing up the applications and data.

Chapter 6

Considering Financial Reporting Competencies and Their Effects on Internal Control

To maintain effective internal control over financial reporting, a company needs to retain individuals who are competent in financial reporting and related oversight roles.[1] Smaller, less complex companies can face challenges in recruiting and retaining individuals with sufficient experience and skill in accounting and financial reporting. Also, resource limitations might prevent a smaller, less complex company from employing personnel who are familiar with the accounting required for unique, complex, or nonroutine transactions or relevant changes in rules, regulations, and accounting practices. Smaller, less complex companies might address their needs for financial reporting competencies through means other than internal staffing, such as engaging outside professionals.

This chapter discusses the auditor's consideration of financial reporting competencies at a smaller, less complex company, including situations in which a smaller, less complex company enlists outside assistance in financial reporting matters.

Understanding and Evaluating a Company's Financial Reporting Competencies

The evaluation of competence is one aspect of evaluating the control environment and the operating effectiveness of certain controls. For example, when evaluating entity-level controls, such as risk assessment and the period-end financial reporting process, the auditor could obtain information about whether—

- Management identifies the relevant financial reporting issues on a timely basis (e.g., issues arising from new transactions or lines of business or changes to accounting standards); and
- Management has the competence to ensure that events and transactions are properly accounted for and that financial statements and related disclosures are presented in conformity with generally accepted accounting principles ("GAAP").

For recurring clients, the auditor's experience in prior audit engagements can be a source of information regarding management's financial reporting competencies. The auditor could be aware of specific accounts or disclosures that have caused problems in prior engagements, or of management's response to past changes in accounting pronouncements. These experiences can inform the auditor about management's financial reporting competencies, including

[1] See e.g., Principle 5 of the COSO Small Companies Guidance.

whether and how management identifies and responds to financial reporting risks. The procedures performed to evaluate the period-end financial reporting process also could be valuable to the evaluation of financial reporting competency.

The auditor's inquiries and observations pertaining to the company's overall commitment to competence, which is part of the evaluation of the control environment, also can inform the auditor's assessment of financial competency. The auditor can consider whether and how the company and management—

- Establish and agree on the knowledge, skills and abilities needed to carry out the required responsibilities prior to hiring individuals for key financial reporting positions,
- Train employees involved in financial reporting processes and provide them with the appropriate tools and resources to perform their responsibilities, and
- Periodically review and evaluate employees relative to their assigned roles, including whether the audit committee (or board of directors) evaluates the competencies of individuals in key financial reporting roles, such as the chief executive and financial reporting officers.

Auditors may keep in mind that company financial reporting personnel do not need to be experts in all areas of accounting and financial reporting but need to be sufficiently competent with respect to the accounting for current and anticipated transactions and changes in accounting standards to identify and address the risks of misstatement.

Supplementing Competencies with Assistance from Outside Professionals

Some smaller, less complex companies might not have personnel on staff with experience in certain complex accounting matters that are encountered. In these circumstances, a company might engage outside professionals to provide the necessary expertise (i.e., an individual or firm possessing special skill or knowledge in the particular accounting and financial reporting matter).[2] When assessing the competence of the personnel responsible for the company's financial reporting and associated controls, the auditor may consider the combined competence of company personnel and other parties that assist with functions related to financial reporting.

When an outside professional provides accounting assistance related to relevant assertions or the period-end financial reporting process, the auditor might begin by considering how the company assures itself that events and transactions are properly accounted for and that financial statements and the related disclosures are free of material misstatement. The company might have differing levels of involvement with outside professionals, depending upon the nature of the services provided. The auditor could evaluate management's oversight to determine whether the company, with the assistance of the professional, is

[2] This section of the chapter does not pertain to management's use of a service organization that supports routine accounting functions, such as processing payroll transactions or supporting the company's information technology systems. It also does not apply to management's use of specialists in matters outside of accounting and financial reporting, such as actuaries, engineers, environmental consultants, and geologists. See Auditing Standard No. 5, AU sec. 324, *Service Organizations*, and AU sec. 336, *Using the Work of Specialists*, for direction on these matters.

adequately identifying and responding to risks.[3] In performing this evaluation, the auditor can consider—

- Whether management recognizes situations for which additional expertise is needed to adequately identify and address risks of misstatement.
- How management determines that the outside professionals possess the necessary qualifications. For example, management might obtain information from the professional about his or her skills and competence.
- Whom management designates to oversee the services and whether they possess the suitable skill, knowledge, or experience to sufficiently oversee the outside professionals. (Note: Management is not required to possess the expertise to perform or re-perform the services.)
- Whether management has established controls over the work of the outside accounting professional and over the completeness and accuracy of the information provided to the outside professional. For example, in addition to reviewing the work of the outside professional, management might inquire about the professional's monitoring and review procedures related to the work performed by the professional for the company.
- How management participates in matters involving judgment, for example, whether management understands and makes significant assumptions and judgments underlying accounting calculations prepared by an outside professional.
- How management evaluates the adequacy and the results of the services performed, including the form and content of the outside accounting professional's findings, and accepts responsibility for the results of the services.

In gathering evidence to support this evaluation, the auditor could hold discussions with both management and the outside professional, perhaps while obtaining an understanding of the period-end financial reporting process. The auditor also could inspect documentation that provides support for management's oversight of the outside professional.[4]

Example 6-1—Assistance from Outside Professionals

Scenario: A small developer of analytical software products does not have an individual with strong tax accounting expertise on staff. The company retains a thirdparty accounting firm (not its auditor) to prepare the income tax provision. Management obtains information from the third-party accounting firm about the training and experience of the staff assigned to do this work. The company's CFO, who has basic knowledge of tax accounting, reviews and discusses the tax provision with the accounting firm that prepared it, and compares the provision to CFO's expectations based on past periods, budgets, and knowledge of business operations.[5]

(continued)

[3] If the audit committee has oversight over the use of service providers, the auditor may also consider the nature and extent of that oversight.

[4] Refer to Chapter 7 for discussion of how the auditor can obtain sufficient evidence when less formal documentation is available.

[5] Adapted from the COSO Small Companies Guidance, Volume II: Guidance, page 34.

Audit Approach: The auditor observes that management identifies risks to financial reporting related to accounting for income taxes and engages an outside professional to provide technical assistance. Further, the auditor evaluates management's oversight to determine whether the company, with the assistance of the professional, is adequately identifying and responding to risks of material misstatement regarding the income tax provision. As part of this evaluation, the auditor inspects the engagement letter, other correspondence between the company and the third-party firm, and the tax schedules and other information produced by the third-party firm. The auditor also evaluates the controls over the completeness and accuracy of the information furnished by the company to the third-party firm. The auditor also assesses whether the third-party accounting firm has the proper skills and staff assigned to do this work.

Chapter 7

Obtaining Sufficient Competent Evidence When the Company Has Less Formal Documentation

Implementing and assessing effective internal control over financial reporting by a company's management generally involves some level of documentation. A smaller, less complex company often has different needs for documentation, and the nature of that documentation might differ from that of a larger or more complex organization. Differences in the form and extent of control documentation of smaller, less complex companies generally relate to their operating characteristics, particularly to fewer resources and more direct interaction of senior management with controls.[1]

The nature and extent of a company's documentation of internal control over financial reporting can have a significant effect on the auditor's strategy regarding the audit of internal control. This chapter discusses how the auditor could adapt his or her audit strategy to obtain sufficient competent evidence in an environment with less formal documentation.

Audit Strategy Considerations

The auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment.[2] The auditor can obtain this evidence through direct testing or using the work of others, as appropriate. Procedures the auditor could perform to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control. The nature, timing, and extent of tests of controls depend on the risk associated with the controls. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.[3]

PCAOB standards establish the documentation requirements for these audits. Those documentation requirements apply only to the auditor.

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[1] The COSO Small Companies Guidance, Volume II: Guidance, pages 12–13, discusses circumstances that affect the need for documentation of internal control.

[2] See Auditing Standard No. 5, paragraph 3.

[3] Auditing Standard No. 5, paragraph 46. Paragraph 47 discusses the factors that affect the risk associated with a control.

Documentation of Processes and Controls

Larger companies with complex operations are more likely to have formal documentation of their processes and controls, such as in-depth policy manuals and systems flowcharts of processes. In a smaller, less complex company, documentation of processes and controls might take a variety of forms. For example, information about processes and controls might be found in other documentation, such as memoranda, questionnaires, software manuals, source documents, or job descriptions. This documentation might not cover every process and might not be in a consistent form across all processes.

Where walkthroughs are performed, auditors could use those procedures to obtain an understanding of the flow of transactions affecting relevant assertions and to assess the design effectiveness of certain controls, even when documentation is limited.

Documentation of Operating Effectiveness of Controls

In a smaller, less complex business, the nature and extent of documentation of the operating effectiveness of controls may vary. Also, evidence of a control's operation might exist only for a limited period.

The type and availability of evidence regarding controls to be tested can affect the auditor's testing strategy.[4] In particular, company documentation can influence the nature and timing of audit procedures performed. For example, the nature of some audit procedures e.g., document inspection, requires documentation. Also, the timing of some tests of controls might be determined, in part, based on when the evidence of the controls' operation is available.

Obtaining sufficient evidence about the operating effectiveness of controls can be challenging when there is limited documentation of their operation. In those situations, inquiry combined with other procedures, such as observation of activities, inspection of documentation produced or used by the controls,[5] and reperformance of certain controls, might provide sufficient evidence about whether a control is effective.

As a practical matter, the auditor also needs to obtain documentation of the work of others to use that work to reduce the auditor's own testing.[6]

Other Considerations

When auditing a smaller, less complex company with limited documentation, it generally is helpful to obtain an understanding of the nature and availability of audit evidence relating to internal control over financial reporting as early in the audit process as practical. This understanding ordinarily includes consideration of existing documentation regarding—

- Company processes and procedures, particularly for transactions affecting relevant assertions and controls that the auditor is likely to select for testing
- Monitoring of other controls performed by management or others

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[4] As discussed in Chapter 8, a pervasive lack of documentation and other audit evidence could prevent the auditor from being able to obtain sufficient evidence to support an opinion on internal control.

[5] Examples of documentation that might be produced or used by controls include exception reports, memoranda, or documented communications between management and employees.

[6] The auditor's use of the work of others also is dependent on such factors as the nature of the subject matter and the competence and objectivity of the individuals performing the work. See Auditing Standard No. 5, paragraphs 16–19.

The auditor can then identify gaps in important documentation so alternatives can be explored. For example, if the CFO prepares contemporaneous documentation of certain controls and retains it for a limited period, the auditor might arrange to obtain access to that documentation for testing purposes. Early conversations with management about these matters can help provide auditors with the most flexibility in developing efficient and effective audit strategies.

If the company does not have formal documentation of its processes and controls, the auditor may consider whether other documentation is available before drafting formal descriptions of processes and controls for the audit documentation. A practical way to identify such other documentation is to look at the information that the company uses to run the business.

As discussed in Chapter 1, one of the practical considerations when selecting controls to test and determining the nature, timing, and extent of testing is the nature and availability of evidence of operating effectiveness. For example, if two or more controls adequately address the risk of misstatement for a relevant assertion, the auditor could select the control for which evidence of operating effectiveness can be obtained more readily.

Example 7-1—Obtaining Information about Processes and Controls

Scenario: A small manufacturer in the electronics industry periodically makes large purchases of specialty components. The company has established procedures covering the initiation, authorization, and recording of these purchases, although the company has not developed an in-depth policies and procedures manual. The company's procedures provide for completion of a form that describes the product requirements and payment terms and indicates how to record the purchase. The forms are reviewed and approved by the CEO and CFO before the purchase is executed. When the goods are received, they are matched with the purchase form and accounted for as indicated on the form.

Audit Approach: The auditor inspects a copy of a completed purchase form and related documentation to obtain an initial understanding of the flow of the purchase transactions. She follows up with inquiries of personnel involved in the process of authorizing, sending, and accounting for the purchases and traces the recording of the transactions through the accounting system. She summarizes her understanding of the transaction flow in a memo and includes a copy of a purchase form in the workpapers. The auditor uses her understanding of the purchase process to plan and perform tests of selected controls over the purchases.

Example 7-2—Obtaining Evidence about Operating Effectiveness of Controls

Scenario: One control that management relies on with respect to the period-end financial reporting process is the CFO's review of the quarterly financial statements prepared by the controller. The CFO does not create separate documentation of her review but does retain copies of the financial statements with her handwritten notes and other markings for reference purposes. She sends her review comments to the controller via email, and the company's email system retains the email messages. If errors are identified, the controller prepares adjusting entries, which are approved by the CFO.

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Each quarter, the CFO and controller prepare and present to the audit committee a financial package, explaining significant trends in the company's financial condition, operating results, and cash flows, as well as comparisons to budgeted amounts and comparable prior periods.

Audit Approach: The auditor can draw upon multiple sources of audit evidence to evaluate whether the control is in place and operating effectively to detect errors in the period-end financial reporting process. He can make inquiries of the CFO to obtain an understanding of the frequency, nature, timing, and level of precision[7] of the CFO's review. He can corroborate this understanding and evaluate the operating effectiveness of the review by, for selected items, inspecting copies of the reviewed drafts of the financial statements, reviewing comments sent to the controller, and reviewing adjusting entries and supporting information. He can also talk to other employees to find out if the CFO contacts them to ask questions, what types of questions are asked, and how those questions are resolved. In addition, he can read the information in the financial package delivered to the audit committee and might observe the CFO's financial review with the audit committee, if the auditor attends the meetings in connection with the audit.

Chapter 8

Auditing Smaller, Less Complex Companies with Pervasive Control Deficiencies

In some audits of internal control, auditors might encounter companies with numerous or pervasive deficiencies in internal control over financial reporting. Smaller, less complex companies can be particularly affected by ineffective entity-level controls, as these companies typically have fewer employees and fewer process-level controls.

Auditing internal control over financial reporting in companies with pervasive deficiencies can be challenging. The auditor's strategy is influenced by the nature of the control deficiencies and factors such as the effect of the deficiencies on other controls and the availability of audit evidence. Although the facts and circumstances can vary significantly, the auditor might not be able to express an unqualified opinion on the effectiveness of internal control over financial reporting in some of these situations.[1]

This chapter discusses how auditors could design their audit strategies in response to situations involving pervasive deficiencies.

Pervasive Deficiencies that Result in Material Weaknesses

The auditor's objective in an audit of internal control is to express an opinion on the effectiveness of the company's internal control over financial reporting. Because a company's internal control over financial reporting cannot be

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[7] Level of precision is discussed in more detail in Chapter 2.

[1] To enable the auditor to express an unqualified opinion on internal control, the company would need to remediate all of its material weaknesses early enough before year-end to enable the auditor to obtain sufficient competent audit evidence about the remediated controls to support an unqualified opinion on internal control over financial reporting.

considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment.[2]

Ordinarily, the auditor's strategy should include tests of controls as necessary to support a conclusion that internal control over financial reporting is effective.[3] However, the auditor's existing knowledge of the company or information obtained early in the audit process might lead an auditor to a preliminary judgment that internal control over financial reporting is likely to be ineffective because of the presence of pervasive control deficiencies that result in one or more material weaknesses. In those situations, the auditor's strategy for testing selected controls may depend on the effect of the pervasive deficiencies on other controls, as discussed in the following paragraphs.

Considering the Effect of Pervasive Control Deficiencies on Other Controls

When the auditor encounters pervasive control deficiencies, he or she might decide that those deficiencies also impair the effectiveness of other controls by rendering their design ineffective or by keeping them from operating effectively. For example, certain deficient entity-level controls, such as the following, might impair the effectiveness of other controls over relevant assertions:

- *Ineffective control environment (considering the risk profile of the company).* An ineffective control environment can increase the risk associated with a control by rendering its design ineffective or preventing it from operating effectively. Also, certain controls in the control environment, such as maintaining financial reporting competencies, might be necessary for the effective functioning of other controls.
- *Ineffective IT controls or information systems.* Ineffective information systems could impair the effectiveness of certain IT-dependent controls (e.g., monitoring controls that rely on the reports produced by an ineffective information system).
- *Pervasive lack of segregation of duties without appropriate alternative controls.* When a person performs two or more incompatible duties, the design of some controls might be ineffective without appropriate alternative controls.
- *Frequent management override of controls.* A control that is frequently overridden is less likely to operate effectively. The effectiveness of controls that depend on an overridden control also might be impaired.

The top-down audit approach can help the auditor identify pervasive control deficiencies earlier in the audit process and take them into account in determining the audit approach for testing other controls.

The auditor's preliminary judgments regarding the effect of the pervasive control deficiencies can help determine the approach to gathering audit evidence. When the pervasive control deficiencies adversely affect other controls, the auditor may modify the planned testing of the other controls because less evidence generally is needed to support a conclusion that controls are not effective than a conclusion that controls are effective.[4] For example, if a control is likely to

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[2] See Auditing Standard No. 5, paragraph 3.

[3] See Auditing Standard No. 5, paragraph 39.

[4] See Auditing Standard No. 5, paragraphs 46 and 47.

be impaired because of another control's deficiency, the inquiries and observations during walkthroughs might provide enough evidence to conclude that the design of a control is deficient and thus could not prevent or detect misstatements. In some cases, limited testing of a control might be necessary (e.g., if a walkthrough has not been performed) to conclude that a control is not operating effectively. Also, detected misstatements from the audit of the financial statements could indicate that a control is not effective.

Some companies might have pervasive control deficiencies and still have effective controls over some relevant assertions. For the selected controls that are likely to be effective, the auditor should test those controls to obtain the evidence necessary to support a conclusion about their operating effectiveness.[5] The pervasive control deficiencies may affect the risk associated with the controls selected for testing, and, in turn, the amount of audit evidence needed. Example 8-1 discusses the effect of pervasive control deficiencies on tests of controls.

Scope Limitation Due to Lack of Sufficient Audit Evidence

Pervasive deficiencies in a company's internal control over financial reporting do not necessarily prevent an auditor from obtaining sufficient audit evidence to express an opinion on internal control over financial reporting. If the auditor determines that sufficient evidence is available to express an opinion, the auditor should perform tests of those controls that are important to the auditor's conclusion about the effectiveness of the company's internal control over financial reporting and evaluate the severity of the identified control deficiencies.[6]

In some audits of companies with pervasive control deficiencies, the auditor could become aware that there is minimal available evidence about the design and operation of internal control over financial reporting. Such situations could lead the auditor to conclude that the lack of available evidence constitutes a scope limitation that will prevent him or her from obtaining reasonable assurance necessary to express an opinion on internal control over financial reporting, including identification of existing material weaknesses.

The auditor may issue a report disclaiming an opinion on internal control over financial reporting as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion.[7] The auditor is not required to perform any additional work before issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion. The auditor's report should disclaim an opinion on internal control and disclose the substantive reasons for the disclaimer. The report also should disclose the material weaknesses of which the auditor is aware.[8]

Even if the auditor lacks sufficient evidence to express an opinion on internal control, the auditor might still be able to obtain sufficient evidence to perform an audit of the financial statements. The auditor should, however, take into account the control deficiencies and issues encountered in the audit of internal control in assessing control risk and determining the nature, timing, and extent of tests of accounts and disclosures in the audit of the financial statements.[9]

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[5] See Auditing Standard No. 5, paragraph 39.

[6] See Auditing Standard No. 5, paragraphs 22, 39, and 62.

[7] See Auditing Standard No. 5, paragraph C6.

[8] See Auditing Standard No. 5, paragraph C5, for the specific requirements regarding the disclosures of the material weaknesses.

[9] See Auditing Standard No. 5, paragraph B5.

Example 8-2 illustrates a situation in which the auditor is unable to obtain sufficient evidence to express an opinion on internal control over financial reporting.

Example 8-1—Pervasive Deficiencies and Testing of Controls

Scenario: A small company has a two-person staff that handles all of the accounting and financial reporting duties. The staff is competent in routine financial reporting matters but has difficulty with more complex accounting matters, such as valuation of stock-based compensation and income tax calculations and disclosures. The lack of competencies in these areas has resulted in adjustments based on the auditor's identification of material misstatements.[10]

Audit Approach: Based on the auditor's experience with the company, she expects that controls over the valuation/allocation and disclosures related to stock-based compensation and income taxes will not be effective. For those assertions, the auditor obtains evidence about the respective controls during a walkthrough of the related process. Also, misstatements in those assertions were detected in the financial statement audit, and she observes that the controls failed to prevent or detect those misstatements. Based on this evidence, she concludes that the controls over those assertions are not effective.

With respect to routine financial reporting processes, such as cash receipts and disbursements, the auditor plans to perform tests of the selected controls to obtain enough evidence to support a conclusion that the respective controls are effective.

Example 8-2—Lack of Sufficient Audit Evidence

Scenario: A development stage company is devoted exclusively to research and development for a new product and currently generates no revenue. The financial staff consists of a CFO and accounting clerk. The company's principal accounting records consist of a checkbook and payroll records, and the company has no documentation of policies and procedures. Most of its controls are undocumented supervisory checks by the CFO.

Late in the fourth quarter, a management dispute results in the resignation of the CFO and termination of the accounting clerk. Management hires an accountant on a temporary contract basis to prepare financial statements from the company's existing records and to help the company establish appropriate controls over its financial reporting functions. However, most of these controls were implemented near or shortly after year-end.

Audit Approach: As the auditor begins trying to obtain an understanding of the company's internal control over financial reporting and evaluate entity-level controls, she notes that there is minimal information available about the controls that existed at yearend. Because of the turnover in financial reporting personnel, the auditor is unable to perform inquiries, observations,

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[10] Chapter 6 discusses financial reporting competencies in more detail, including approaches that smaller, less complex companies might take to enhance their financial reporting competencies.

or other procedures to understand the flow of transactions and related controls in significant processes. The auditor identifies some material weaknesses, but she determines that the lack of evidence results in a scope limitation because she cannot obtain reasonable assurance that all of the existing material weaknesses are identified.

Accordingly, the auditor ceases further audit procedures in the audit of internal control. The auditor's report on internal control over financial reporting contains a disclaimer of opinion and disclosure of the substantive reasons for the disclaimer and the material weaknesses that she identified.

Appendix A

The Integrated Audit Process

Auditing Standard No. 5 indicates that the audit of internal control should be integrated with the audit of the financial statements. This means that the auditor should plan and perform the work to achieve the objectives of both audits,[1] which are as follows:

- *Audit of the financial statements.* To express an opinion on the fairness with which the financial statements present, in all material respects, financial position, results of operations, and its cash flows in conformity with GAAP.[2]
- *Audit of internal control.* To express an opinion on the effectiveness of the company's internal control over financial reporting.[3]

This appendix illustrates one approach for integrating the audit of internal control with the audit of the financial statements and is not intended to present all of the procedures that are required for a particular audit. Auditors must plan and perform their integrated audits to achieve the objectives of the audits and to comply with standards of the PCAOB.[4]

Summary of the Illustrative Audit Approach

The integrated audit process can be summarized into the following major components:

a. Preliminary engagement procedures
b. Audit planning
c. Risk assessment procedures
d. Auditor response, including tests of accounts and controls
e. Conclusion and wrap-up

Preliminary Engagement Procedures

Preliminary engagement procedures include the auditor's engagement acceptance process and reaching an understanding with the audit committee about the terms of the engagement, including pre-approval of audit and non-audit services.

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[1] See Auditing Standard No. 5, paragraphs 6 and 7.

[2] See paragraph .01 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*.

[3] See Auditing Standard No. 5, paragraph 3.

[4] See Auditing Standard No. 5, paragraph 6.

During the engagement acceptance process, the auditor might identify matters that could affect the risk of material misstatement of the financial statements or the risk of material weakness in internal control over financial reporting and, thus, could inform the auditor's risk assessments during the audit.

Audit Planning

During audit planning, the auditor should make a preliminary judgment about materiality. The judgment about materiality is the same for both the audit of the financial statements and the audit of internal control.[5]

The auditor also can develop a preliminary audit strategy and audit plan based on his or her understanding of the company and its environment. The audit strategy could cover matters such as general scope and timing of the engagement. The audit strategy and plan could be refined further as the audit progresses.

Risk Assessment Procedures

Risk assessment procedures are intended to help the auditor identify risks of misstatement and the controls that are in place to address those risks. When performing risk assessment procedures, the auditor should obtain an understanding of the company and its environment, including its internal control.[6] These procedures include walkthroughs, or other procedures, to understand the likely sources of misstatement.[7] It also includes performing preliminary analytical procedures and procedures to assess the risk of material misstatement due to fraud.[8] The auditor's risk identification and assessment should also take into account his or her knowledge about the company and its environment from other sources, such as prior audits.[9]

Based on the auditor's understanding gained through performing the risk assessment procedures and obtaining other evidence, the auditor should assess the identified risks.[10]

The auditor's risk assessments are the basis for the identification of significant accounts and disclosures and relevant assertions as well as the selection of controls to test. Relevant assertions and significant accounts and disclosures should be determined based on whether there is a reasonable possibility that they could contain misstatements that could cause the financial statements to be materially misstated.[11] The identification of relevant assertions and significant accounts[12] is the same for both the audit of internal control and the audit of the financial statements.

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[5] See AU sec. 311.03, AU sec. 312.12–.33, and Auditing Standard No. 5, paragraph 20.

[6] See AU sec. 319.25–.61, and Auditing Standard No. 5, paragraph 9.

[7] See Auditing Standard No. 5, paragraphs 34–38, for discussion of the objectives of walkthroughs and direction on walkthrough procedures.

[8] See AU sec. 329.06–.08, and AU sec. 316.35–.45.

[9] See AU sec. 311.04 and .08, and AU sec. 319.59.

[10] See AU sec. 312.16 and .26–.33.

[11] See Auditing Standard No. 5, paragraphs 28–33.

[12] In the financial statement audit, the auditor may perform substantive auditing procedures on financial statement accounts, disclosures, and assertions that are not determined to be significant accounts and disclosures and relevant assertions. This is because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high (see AU sec. 312.39 for further discussion about undetected misstatement) or as a means of introducing unpredictability in the procedures performed (see AU sec. 316.50 for further discussion about predictability of auditing procedures).

Auditing Standard No. 5 states that the auditor should use a top-down approach to the audit of internal control to select the controls to test. A top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal control over financial reporting.[13] The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the financial statements and related disclosures. The auditor then verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion.

Overall Response to Risks

Based on the auditor's risk assessment, the auditor should evaluate the need for an overall response to the risks.[14] This evaluation is particularly important for pervasive risks of misstatement, which can affect many financial statement accounts, but it applies to every audit.

The overall responses could affect such aspects of the audit as—

- Assignment of staff
- Level of supervision
- Need for specialists
- Appropriateness of planned audit strategy and scope

Specific Responses—Substantive Procedures and Tests of Controls

Specific responses to risk relate to the tests of relevant assertions of significant accounts and disclosures ("substantive procedures") and the controls over those assertions. Auditing Standard No. 5 requires the auditor to obtain evidence about the controls over relevant assertions, and it states that the auditor should perform substantive procedures for all relevant assertions, regardless of the assessed level of control risk.[15] The auditor should determine an appropriate mix of the nature, timing, and extent of testing based on the associated risks and other factors.[16] The determination of the nature, timing, and extent of testing includes decisions about using the work of others to test controls in the integrated audit. As the associated risk increases, the evidence that the auditor should obtain also increases.[17]

The relationship between tests of controls and substantive procedures is important to the integration of the audit of internal control with the audit of financial statements. Obtaining sufficient evidence to support control risk assessments of low for purposes of the financial statement audit ordinarily allows the auditor to reduce the amount of substantive procedures that otherwise would have been necessary to opine on the financial statements. On the other hand, deficiencies in the controls that the auditor planned to rely on could lead the auditor to expand his or her substantive procedures.

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[13] See Auditing Standard No. 5, paragraph 21.

[14] See AU sec. 312.16.

[15] See Auditing Standard No. 5, paragraph B7.

[16] For example, in the audit of internal control, walkthroughs might provide sufficient evidence of operating effectiveness for some selected controls, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough, and the results of those procedures.

[17] See Auditing Standard No. 5, paragraphs 46 and 49.

As discussed in Chapter 1, the results of substantive tests of accounts and disclosures do not provide sufficient evidence for the auditor to conclude on the operating effectiveness of controls. However, the results of substantive tests could affect the auditor's risk assessments associated with the controls. For example, if the results of substantive procedures indicate misstatements in an assertion, evaluating the nature, cause, and significance of the misstatements could lead the auditor to identify a deficiency in the related controls or to modify his or her risk assessments. When no misstatements are detected from substantive procedures for an assertion, the auditor should take that into account along with the factors discussed in paragraphs 46–49 of Auditing Standard No. 5 in considering the risk associated with the related controls, which affects the nature, timing, and extent of the testing necessary to conclude on the effectiveness of the controls.[18]

Conclusion and Wrap-up

In the conclusion and wrap-up phase, the auditor should evaluate the results of his or her testing, particularly for identified misstatements and control deficiencies. The auditor should evaluate the misstatements and control deficiencies, individually and in the aggregate. In evaluating the effects of misstatements, the auditor should include both quantitative and qualitative considerations.[19]

Based on the evaluation of the testing results, the auditor should form conclusions about whether—

- The financial statements are materially misstated,
- A material weakness in internal control exists, and
- He or she has obtained sufficient competent evidence to support those conclusions.[20]

The results of each portion of the integrated audit inform the auditor's conclusions about the other portion. For example, the auditor's conclusions about the effectiveness of controls should be based on all of the pertinent information about control effectiveness,[21] including—

- Tests of controls for the audit of internal control,
- Tests of controls for the audit of the financial statements,
- Use of the work of others in either audit, and
- Evidence about control deficiencies resulting from identified misstatements or other sources (e.g., control deficiencies identified by management).

This information could affect the conclusions about control effectiveness as of year-end as well as control risk assessments for the financial statement audit. In some situations, the evaluation of audit results also could lead the auditor to re-evaluate his or her assessments of risk and the sufficiency of the audit procedures performed.

The conclusion and wrap-up phase of the audit also includes completion of the review of the audit and resolution of reviewers' comments.

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[18] See Auditing Standard No. 5, paragraph B9. This does not mean that the auditor is required to perform substantive procedures for a relevant assertion before performing tests of controls.

[19] See AU sec. 312.34, and Auditing Standard No. 5, paragraphs 62 and B8.

[20] See paragraphs .34–.41 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .01 of AU sec. 326, *Evidential Matter*, and Auditing Standard No. 5, paragraph 3.

[21] See Auditing Standard No. 5, paragraph 71.

Appendix B

Discussion of Comments Received on the Preliminary Staff Views

On October 17, 2007, the staff of the Board's Office of the Chief Auditor published for comment *Preliminary Staff Views – An Audit of Internal Control That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies* ("the preliminary guidance"). During the public comment period, 23 comment letters were received from investors, auditors, issuers, and others.

The majority of commenters were supportive of the preliminary guidance. They noted that it appropriately considered the environment of smaller, less complex companies and provided useful examples that will help in designing and executing strategies for the audits of these companies in accordance with the provisions of Auditing Standard No. 5.

The commenters offered suggestions to improve the preliminary guidance. After a careful analysis, certain changes have been made to this publication to further clarify or enhance the guidance. This Appendix describes significant comments received on the preliminary guidance and the related changes that the staff made in this publication.

General Comments

The introduction to the preliminary guidance stated that it did not establish new requirements for auditors. However, some commenters suggested reinforcing this statement by providing references to the Board's standards that establish mandatory or presumptively mandatory responsibilities to which this publication refers. As suggested by commenters, this publication includes additional references to the Board's standards.

Several commenters suggested that some or all of the preliminary guidance could be applicable to audits of internal control of larger public companies. As noted in the introduction, this publication was developed specifically to describe how auditors may apply the provisions of Auditing Standard No. 5 to audits of smaller, less complex companies. If auditors of larger public companies find this guidance useful in applying the scalability principles of Auditing Standard No. 5, they may, of course, refer to it. As noted earlier, this guidance does not establish requirements for the audit of internal control. Rather, all audits of internal control—regardless of the size of the company—must comply with the requirements of Auditing Standard No. 5.

Chapter 1—Scaling the Audit for Smaller, Less Complex Companies

The preliminary guidance said that "[i]f none of the controls that are designed to address a risk for a relevant assertion is likely to be effective, the auditor can take that into account in determining the testing of that control." According to one commenter, this statement could suggest that, under such circumstances, the auditor still has an obligation to test a particular control. This sentence has been modified to say that, if none of the controls over an assertion "is likely to be effective, the auditor can take that into account in determining the evidence needed to support a conclusion about the effectiveness of controls for this assertion." Paragraph 47 of Auditing Standard No. 5 indicates that less evidence generally is needed to support a conclusion that controls are not effective. Chapter 8 discusses how this principle may be applied when a company has pervasive control deficiencies.

Several commenters asked the staff to clarify the example in the section entitled Tests of Operating Effectiveness of Controls, in which the auditor was able to use the results of tests of controls to reduce the substantive work on accounts receivable but not revenue. In the commenters' view, it can be difficult to distinguish controls over accounts receivable—specifically, over billing and cash receipt processing—from controls over revenue recognition. In response, the reference to revenue recognition in this example has been replaced with a reference to the allowance for doubtful accounts, the controls over which are more easily distinguishable from controls over billing and cash receipt processing.

Additionally, as suggested by the commenters, the discussion leading to this example has been modified to emphasize that the auditor's decisions about relying on controls, which were illustrated by the example, were related to the audit of the financial statements rather than the audit of internal control. The example is not meant to suggest that the auditor should avoid testing controls in high-risk areas. Rather, the example assumes that the auditor is following the requirements and direction in AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, in designing his or her audit strategy.

Another commenter asked for clarification about whether an auditor would be able to issue an unqualified opinion on the effectiveness of internal control over financial reporting when the auditor assessed control risk at the maximum for one or more relevant assertions in the audit of financial statements. A new paragraph that discusses the relationship between assessing control risk at the maximum and expressing an opinion on internal control over financial reporting has been added to the section entitled Tests of Operating Effectiveness of Controls.

In the last paragraph of Chapter 1, one commenter asked to clarify what impact the absence of misstatements detected by substantive procedures has on the testing of controls. In response, this publication explains that the absence of misstatements is only one of a number of factors that informs the auditor's risk assessment in determining the testing necessary to conclude on the effectiveness of a control. Additionally, as recommended by another commenter, the wording in this paragraph has been revised to better reflect paragraph B9 of Auditing Standard No. 5, to which it refers.

One commenter suggested adding guidance to address situations in which controls changed during the period. The purpose of Chapter 1 is to discuss the principles in Auditing Standard No. 5 for scaling the audit and integrating tests of controls in audits of smaller, less complex public companies. Auditing Standard No. 5 and AU sec. 319, address the auditor's responsibilities for situations in which controls change during the year.

Chapter 2—Evaluating Entity-Level Controls

Comments on Chapter 2 related primarily to the guidance on the precision of entity-level controls.

Some commenters were concerned that the list of factors that the auditor might consider in judging the level of precision of an entity-level control, in the section entitled Assessing the Precision of Entity-Level Controls, will be used as a checklist by auditors. Other commenters suggested expanding the list. Consistent with the preliminary guidance, this publication uses the phrase "factors include" to indicate that the list of factors is not all-inclusive, and the list of factors is not a list of criteria that the auditor should determine are met for every entity-level control. Not all factors are necessarily applicable to every control (e.g., some are relevant only to detective controls), and some factors might be more important than others for a given control. Examples 2-1 and 2-2 have been

modified to better explain which factors the auditor in those examples took into account in evaluating the precision of the company's entity-level controls.

One commenter suggested expanding the guidance in Chapter 2 by discussing auditing considerations related to evaluating design and operating effectiveness of company's entity-level risk assessment component. The risk assessment component of internal control involves identification and analysis of the risks of material misstatement[22] and thus, by itself, would not necessarily prevent or detect misstatements. Chapter 2 focuses on those entity-level controls that are more likely to operate at a sufficient level of precision to result in a reduction of testing of processlevel controls in an audit of a smaller, less complex company.

Additionally, another commenter asked for clarification regarding when the auditor can obtain a substantial amount of evidence about the effectiveness of internal control over financial reporting through the evaluation of entity-level controls. In this publication, the discussion following the bullet points at the beginning of Chapter 2, to which the commenter referred, has been revised to state more clearly that the auditor can obtain such evidence if senior management performs many controls—including entity-level controls—that are important to effective internal control over financial reporting.

Chapter 3—Assessing the Risk of Management Override and Evaluating Mitigating Actions

Some commenters on Chapter 3 were concerned that the introductory statement to a list of mitigating controls in the section entitled Evaluating Mitigating Controls constituted a requirement for management to implement these controls. As stated in the introduction to this publication, the discussions and examples of controls in this publication do not establish internal control requirements and are not intended as guidance to management regarding establishing or evaluating internal control over financial reporting. Nevertheless, the introductory statement has been revised to remove reference to management's implementation of controls. Additionally, as suggested by some commenters, the fourth item in the list of mitigating controls has been renamed "controls over certain journal entries" to more clearly refer to the related discussion in the subsection entitled Evaluating Controls over Journal Entries later in the chapter.

As recommended by one of the commenters, a statement about the importance of the auditor's exercise of professional skepticism when considering the risk of management override has been added to the section entitled Assessing the Risk of Management Override. Because of the important role that the audit committee may play in mitigating the risk of management override, several commenters suggested providing more details in Example 3-1 about procedures performed by the audit committee. Accordingly, Example 3-1 has been expanded to provide more details on the types of procedures performed by the audit committee to address the risk of management override.

Some commenters suggested adding clarification regarding situations in which a company does not have an audit committee. A footnote reference to COSO Small Companies Guidance has been added to the section entitled Evaluating Audit Committee Oversight for clarification, as suggested.

Chapter 4—Evaluating Segregation of Duties and Alternative Controls

Most comments on Chapter 4 related to perceived inconsistencies in Example 4-1, which illustrates some audit procedures for testing alternative controls

[22] See COSO Small Companies Guidance, Volume II: Guidance, page 43.

over inventory. In response to these comments, the example has been revised to describe more clearly the access rights of both the company's employee who performs certain incompatible duties, and the manager who performs the alternative controls. The paragraph preceding the example has also been revised to clarify that entity-level controls should operate at a necessary level of precision to effectively address the risk of misstatement.

One commenter suggested using the term "compensating controls" instead of "alternative controls" to describe controls that address the same issues as segregation of duties. The term "compensating controls" is not used in this chapter because it is generally applied to situations in which control deficiencies have been identified and the auditor is evaluating whether other controls might compensate for the deficiencies. Chapter 4 of this publication, as well as paragraph 42 of Auditing Standard No. 5, use the term "alternative controls" to apply to situations in which management has designed and implemented controls that achieve the same objectives as segregation of duties.

Chapter 5—Auditing Information Technology Controls in a Less Complex IT Environment

Some commenters cautioned against underestimating risks that are associated with pre-packaged software. They indicated that readers might mistakenly perceive prepackaged software to be risk-free. In response to these comments, a footnote has been added to the section entitled Characteristics of Less Complex IT Environments in Chapter 5 to indicate that significant user configuration of the pre-packaged software might create additional risks that require additional controls.

In response to other commenters' suggestions, the following sentence has been added to the discussion in the third bullet point in the section entitled Characteristics of Less Complex IT Environments. "Access to systems is typically managed by a limited number of personnel." In the fourth bullet point, the phrase "in many instances" has been inserted to acknowledge that a smaller, less complex company might perform more complex calculations using spreadsheets and other user-developed applications. In the same bullet point, the phrase "to accumulate, summarize, process, and report" has been replaced with "to initiate, authorize, record, process and report" to more accurately describe tasks included in the end-user computing.

Some commenters asked to clarify how the lack of controls over backups might impact the financial reporting process. In response, the second to last paragraph in the section entitled IT-Related Risks Affecting Financial Reporting of this publication has been reworded to refer, more specifically, to the controls that address the financial reporting risk, i.e., the risk of loss of data necessary to prepare the financial statements, and to acknowledge that there may be different controls to address the potential loss of data.

Several commenters suggested modifying Example 5-1 in order to better illustrate the points made in this chapter. In response, the description of controls and software in the Scenario section of Example 5-1 has been clarified, and controls over authorization have been added to the first sub-bullet in the Audit Approach section.

In general, several commenters were concerned about the potential for auditors to use the lists of controls and audit procedures from Chapter 5 as checklists. As previously mentioned, the discussions and examples of controls in this publication do not establish internal control requirements and are not intended as guidance to management regarding establishing or evaluating internal control over financial reporting. These examples of controls in Chapter 5 do not represent required controls for management.

One commenter suggested adding guidance relating to testing of controls over spreadsheets. The purpose of this chapter was to discuss general audit strategies that might be employed regarding the evaluation of IT controls in a less complex IT environment rather than to discuss testing of any particular control activities.

Chapter 6—Considering Financial Reporting Competencies and Their Effects on Internal Control

Most of the comments on Chapter 6 related to controls over the work performed by outside professionals.

One commenter provided examples of the controls that a company might implement to test work performed by the outside professional. These examples have been added to the discussion of audit considerations in the section entitled Supplemented Competencies with Assistance from Outside Professionals. Additionally, as suggested by commenters, Example 6-1 has been modified to more clearly outline the responsibilities of management and the third-party service provider in a situation typical for a smaller, less complex company. The discussion in the example has also been expanded to provide further details of the procedures performed by the auditor.

Some commenters asked what controls the auditors should expect to see over the work of outside professionals in addition to those over the competence and the accuracy of the information. One commenter asked for specific examples of controls in the situations when the management uses outside professionals in the areas of stock compensation, derivatives and hedging activities, off-balance-sheet accounting, and financial statements preparation. Because of the variety of situations in which outside professionals could be used, including the ones mentioned by the commenters, and the diversity of potential controls that might be implemented by companies using outside professionals, the chapter focuses mainly on the control objectives that might be relevant to those situations rather than the individual controls. However, as noted in the preceding paragraph, some additional examples of controls have been included in this publication as suggested by commenters.

Chapter 7—Obtaining Sufficient Competent Evidence When the Company Has Less Formal Documentation

Some commenters on this chapter asked the staff to clarify the differences between the terms "formal" and "less formal" documentation and the impact of the distinction on the audit. One commenter asked about the auditor's course of action if there is no documentary evidence at all.

"Formal" and "less formal" documentation are relative terms used in this publication to illustrate differences that might exist in the documentation practices of larger and smaller companies. For instance, the section entitled Documentation of Processes and Controls provides examples of more formal documentation and less formal documentation of processes and controls. As stated in this chapter, when auditing a smaller, less complex company, it generally is helpful to obtain an understanding of the nature and availability of documentation as early in the audit process as practical, so that the auditor has sufficient time to explore alternatives if the company has less formal documentation. The section entitled Other Considerations discusses various types of documentation that auditors might consider using as audit evidence relating to internal control, including the documentation of company processes and procedures and other documentation that the company uses to run the business. The chapter also addresses situations in which only limited documentation exists.

Additionally, in response to one commenter's concern, Example 7-2 has been clarified to explain that the CFO's review represents one control – rather than the only control—that management relies on with respect to the period-end financial reporting process.

Chapter 8—Auditing Smaller, Less Complex Companies with Pervasive Control Deficiencies

Several commenters asked for clarification regarding when limited testing of a control that is unlikely to be effective might be necessary. Chapter 8 now includes an example indicating that limited testing of a control might be necessary if walkthrough procedures have not been performed. In response to another commenter's suggestion, the discussion in the section entitled Considering the Effect of Pervasive Control Deficiencies on Other Controls has been expanded to clarify how certain deficient entity-level controls might impair the effectiveness of other controls over relevant assertions.

Other commenters suggested changing the discussion of management override of controls to state that a control that has been "inappropriately overridden" instead of "frequently overridden" is either less likely to operate effectively or ineffective. The wording from the preliminary guidance has been retained in this publication because it best describes the risk associated with management override. Although management override might be appropriate in certain circumstances (e.g., manual override of the old credit limits until the new limits are posted in the IT system), frequent management override of a control could impair the effectiveness of the overridden control.

Appendix A—The Integrated Audit Process

Some commenters expressed concern that auditors might view the audit approach outlined in Appendix A as the preferred approach because this publication would "formalize" it. Others expressed concern that the audit approach described in the appendix does not cover all of the auditing procedures that might need to be performed. As noted in the Introduction to this publication, the guidance is not a rule of the Board and does not establish new requirements. Rather, it discusses how the auditors of smaller, less complex companies may address some (but not all) of the challenges that might arise in audits of those companies. Thus, this publication does not attempt to "formalize" or endorse any particular approach to the audit of internal control over financial reporting. Auditing Standard No. 5 provides direction on integrating the audit of internal control with the audit of financial statements. Appendix A to this publication has been developed to illustrate one approach for integrating the two audits, and it is not intended to present all of the procedures that are required for a particular audit. Auditors should plan and perform their integrated audits to achieve the objectives of the audits and to comply with standards of the PCAOB.

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Section 400
STAFF AUDIT PRACTICE ALERTS

.01 Staff Audit Practice Alert No. 1
Matters Related to Timing and Accounting for Option Grants

July 28, 2006

Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Recent reports and disclosures about issuer practices related to the granting of stock options, including the "backdating" of such grants, indicate that some issuers' actual practices in granting options might not have been consistent with the manner in which these transactions were initially recorded and disclosed. Some issuers have announced restatements of previously issued financial statements as a result of these practices. In addition, some of these practices could result in legal and other contingencies that may require recognition of additional expense or disclosure in financial statements.

This practice alert advises auditors that these practices may have implications for audits of financial statements or of internal control over financial reporting ("ICFR") and discusses factors that may be relevant in assessing the risks related to these matters.

Background

The recorded value of a stock option depends, in part, on the market price of the underlying stock on the date that the option is granted and the exercise price specified in the option. Some issuers may have granted options with exercise prices that are less than the market price of the underlying stock on the date of grant. These options are sometimes referred to as "discounted" or "in-the-money" options. Where discounted options were granted and an issuer failed to properly consider this condition in its original accounting for the option, errors in recording compensation cost, among other effects, may have resulted. These

errors may cause an issuer's financial statements, including related disclosures, to be materially misstated.[1]

While this alert does not attempt to describe all of the variations in circumstances that may result in the issuance of discounted options, a range of practices appears to be involved, including—

- The application of provisions in option plans that allow for:
  - — the selection of exercise prices based on market prices on dates earlier than the grant date, or
  - — the award of options that allow the option holder to obtain an exercise price equal to the lower of the market price of the stock at the grant date or during a specified period of time subsequent to the grant date.
- Preparation, or subsequent modification, of option documentation for purposes of indicating a lower exercise price than the market price at the actual grant date.
- Treating a date as the grant date when, in fact, all of the prerequisites to a grant had not yet occurred.

Available information suggests that the incidence of these and similar practices may have substantially decreased after the implementation of the shortened filing deadline for reports of option grants specified by Section 403 of the Sarbanes-Oxley Act of 2002. In August 2002, the Securities and Exchange Commission ("SEC") implemented this requirement by requiring the reporting of an option grant on Form 4 within two days of the date of grant. However, periods subsequent to the grant of an option may also be affected by improper accounting for a grant because option cost is generally expensed over the period during which the issuer receives the related services, most commonly its vesting period.

Matters for Auditor Consideration

Auditors planning or performing an audit should be alert to the risk that the issuer may not have properly accounted for stock option grants and, as a result, may have materially misstated its financial statements or may have deficiencies in its ICFR. For audits currently underway or to be performed in the future, the auditor should acquire sufficient information to allow him or her to assess the nature and potential magnitude of these risks. An auditor must use professional judgment in making these assessments and in determining whether to apply additional procedures in response.

In making these judgments, auditors should be mindful of the following—

Applicable financial accounting standards. Financial Accounting Standards Board Statement of Financial Accounting Standards ("SFAS") No. 123 R (revised 2004), *Share-Based Payment*, applies to issuer reporting periods beginning after June 15, 2005 (December 15, 2005 for small business issuers). Accounting for options was, however, previously governed by other accounting standards and related interpretations, specifically Accounting Principles

[1] In addition, academic research has suggested the possibility that some issuers may have purposefully granted options immediately before the release of information that the issuer believed would be favorable to its share price. While these practices may not result in the granting of discounted options, they may create legal or reputational risks and raise concerns about the issuer's control environment.

Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and SFAS No. 123, *Accounting for Stock-Based Compensation*. If an auditor determines that it is necessary to consider the accounting for option grants and related disclosures in financial statements of a prior period, the auditor should take care to determine the applicable generally accepted accounting principles in effect in those periods and to consider the specific risks associated with these principles.

- *Accounting for discounted options.* For periods in which an issuer used the provisions of APB 25 to determine compensation cost related to stock options, the issuer may have been required to record additional compensation cost equal to the difference in the exercise price and the market price at the measurement date (as defined in APB 25). In periods in which the issuer has recorded option compensation cost using the fair value method as allowed by SFAS No. 123, or as required by SFAS No. 123 R (revised 2004), the impact on the calculated fair value of options of using an incorrect date as the grant date would depend on the nature and magnitude of changes in conditions that affect option valuation between the incorrect date used and the actual grant date. In all cases, the compensation cost of options should be recognized over the period benefited by the services of the option holder.
- *Accounting for variable plans.* For periods in which an issuer used the provisions of APB 25 to determine compensation cost related to stock options, an option with terms allowing a modification of the exercise price, or whose exercise price was modified subsequent to the grant date may require variable plan accounting. Variable option accounting requires that compensation cost be recorded from period to period based on the variation in current market prices. In periods in which the issuer records option compensation cost using the fair value method as allowed by SFAS No. 123, or as required by SFAS No. 123 R, the right to a lower exercise price may constitute an additional component of value of the option that should be considered at the grant date. In all cases, the cost of options should be recognized over the period benefited by the services of the option holder.
- *Accounting for contingencies.* If the consequences of the issuer's practices for stock option grants or its accounting for, and disclosure of, option grants result in legal or other contingencies, the application of SFAS No. 5, *Accounting for Contingencies*, may require that the issuer record additional cost or make additional disclosures in financial statements.
- *Accounting for tax effects.* The grant of discounted stock options may affect the issuer's ability to deduct expenses related to these options for income tax purposes, thereby affecting the issuer's cash flows and the accuracy of the related accounting for the tax effects of options.

Consideration of materiality. In evaluating materiality, auditors should remember that paragraph .11 of AU sec. 312, *Audit Risk*

and Materiality in Conducting an Audit, and SEC Staff Accounting Bulletin: No. 99—*Materiality* emphasize that both quantitative and qualitative considerations must be assessed. Quantitatively small misstatements may be material when they relate to unlawful acts or to actions by an issuer that could lead to a material contingent liability. In all cases, auditors should evaluate the adequacy of related issuer disclosures.

Possible illegal acts. Auditors who become aware that an illegal act may have occurred must comply with the applicable requirements of AU section ("AU sec.") 317, *Illegal Acts*, and Section 10A of the Securities Exchange Act of 1934. Section 10A, among other things, requires a registered public accounting firm to take certain actions if it "detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred...." If it is likely that an illegal act has occurred, the registered public accounting firm must "determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages." The registered public accounting firm must also inform the appropriate level of management and assure that the audit committee is adequately informed "unless the illegal act is clearly inconsequential." The auditor may, depending on the circumstances, also need to take additional steps required under Section 10A if the issuer does not take timely and appropriate remedial actions with respect to the illegal act.

A. Effects of options-related matters on planned or ongoing audits

In planning and performing an audit of financial statements and ICFR, the auditor should assess the nature and potential magnitude of risks associated with the granting of stock options and perform procedures to appropriately address those risks. The following factors are relevant to accomplishing these objectives—

- Assessment of the potential magnitude of risks of misstatement of financial statements and deficiencies in ICFR related to option granting practices. This assessment should include consideration of possible indicators of risk related to option grants, including, where appropriate:
  - — The status and results of any investigations relating to the timing of options grants conducted by the issuer or by regulatory or legal authorities.
  - — The results of direct inquiries of members of the issuer's management and its board of directors that should have knowledge of matters related to the granting and accounting for stock options.
  - — Public information related to the timing of options grants by the issuer.
  - — The terms and conditions of plans or policies under which options are granted; in particular, terms that allow exercise prices that are not equal to the market price on the date of grant or that delegate authority for option grants to

management. In these situations, auditors should also consider whether issuers have other policies that adequately control the related risks.

— Patterns of transactions or conditions that may indicate higher levels of inherent risk in the period under audit. Such patterns or conditions may include levels of option grants that are very high in relation to shares outstanding, situations in which option-based compensation is a large component of executive compensation, highly variable grant dates, patterns of significant increases in stock prices following option grants, or high levels of stock-price volatility.

- In planning and performing audits, auditors should appropriately address the assessed level of risk, if any, related to option granting practices. Specifically:

  — In addition to the general planning considerations for financial statement audits identified in AU sec. 311, *Planning and Supervision*, the auditor should consider:

    - The implications of any identified or indicated fraudulent or illegal acts related to option grants to assessed risks of fraud (AU sec. 312.07 and AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*); the potential for illegal acts (AU sec. 317, *Illegal Acts by Clients*); or the assessment of an issuer's internal controls (AU sec. 319, *Internal Control in a Financial Statement Audit*).
    - The scope of procedures applied to assess the potential for fraud (AU sec. 316) and illegal acts (AU sec. 317).

  — The nature, timing, and extent of audit procedures applied to elements of the financial statements affected by the issuance of options. In particular, this assessment should include consideration of:

    - The need for specific management representations related to these matters (AU sec. 333, *Management Representations*) and the nature of matters included in inquiries of lawyers (AU sec. 337, *Inquiry of a Client's Lawyer*).
    - Where applicable, the result of tests of internal controls over the granting, recording, and reporting of option grants.
    - The need, based on the auditor's risk assessment, for additional specific auditing procedures related to the granting of stock options.

For integrated audits performed as described in PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* ("AS No. 2"), the auditor should consider the implications of identified or potential accounting and legal risks related to options in planning, performing, and reporting on audits of ICFR. In addition, as discussed in paragraphs 145–158 of AS No. 2, the results of

the audit of ICFR should be considered in connection with the related financial statement audit.

B. Auditor involvement in registration statements

In cases where an auditor is requested to consent to the inclusion of his or her report, including a report on ICFR, in a registration statement under the Securities Act of 1933, AU sec. 711, *Filings Under Federal Securities Statutes*, provides that the auditor should perform certain procedures prior to issuing such a consent.[2]

- Paragraph .10 of AU sec. 711 provides that an auditor should perform certain procedures with respect to events subsequent to the date of the audit opinion up to the effective date of the registration statement (or as close thereto as is reasonable and practical under the circumstances). These procedures include inquiry of responsible officials and employees of the issuer and obtaining written representations from them about whether events have occurred subsequent to the date of the auditor's report that have a material effect on the financial statements or that should be disclosed in order to keep the financial statements from being misleading. The auditor should consider performing inquiries and obtaining representations specifically related to the granting and recording of option grants.
- Paragraph .11 of AU sec. 711 provides that a predecessor auditor that has been requested to consent to the inclusion of his or her report on prior-period financial statements in a registration statement should obtain written representations from the successor auditor regarding whether the successor auditor's audit and procedures with respect to subsequent events revealed any matters that might have a material effect on the financial statements reported on by the predecessor auditor or that would require disclosure in the notes to those financial statements. If the successor auditor becomes aware of information that leads him or her to believe that financial statements reported on by the predecessor auditor may require revision, the successor auditor should apply paragraphs .21 and .22 of AU sec. 315.[3]
- If either the successor or predecessor auditor discovers subsequent events that require adjustment or disclosure in the financial statements or becomes aware of facts that may have existed at the date of his or her report and might have affected the report had he or she been aware of them, the auditor should take the actions described in Paragraph .12 of AU sec. 711. In addition, where the auditor concludes that unaudited financial statements or unaudited interim financial information presented, or incorporated by reference, in a registration statement are not in conformity with generally accepted accounting principles, he or she should take the actions described in Paragraph .13 of AU sec. 711.

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[2] Under Paragraph 198 of AS No. 2, the auditor should apply AU sec. 711 when the auditor's report on management's assessment of ICFR is included in filings under federal securities statutes.

[3] In cases in which a predecessor auditor reissues his or her report on financial statements included in a filing under the Securities Exchange Act of 1934, the predecessor auditor should follow the directives in paragraphs .71 through .73 of AU sec. 508.

C. Effects of option-related matters on previously issued opinions

If an auditor becomes aware of information that relates to financial statements previously reported on by the auditor, but which was not known to him or her at the date of the report, and which is of such a nature and from such a source that he or she would have investigated it had it come to his or her attention during the course of the audit, he or she should take the actions described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

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.02 Staff Audit Practice Alert No. 2

Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists

December 10, 2007

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

The purpose of this staff audit practice alert is to remind auditors of their responsibilities for auditing fair value measurements of financial instruments and when using the work of specialists under the existing standards of the PCAOB. This alert is focused on specific matters that are likely to increase audit risk related to the fair value of financial instruments in a rapidly changing economic environment.[1]

This practice alert highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of generally accepted accounting principles (GAAP) that are particularly relevant to the current economic environment.

While this practice alert focuses on fair value in general, it also draws the auditor's attention to certain areas of the new fair value accounting standard, Statement of Financial Accounting Standard (SFAS) No. 157, *Fair Value Measurements*.[2] Auditing fair value measurements developed under the new accounting standard likely will provide new challenges during implementation.

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[1] A combination of factors in the housing and mortgage markets, including rising delinquency and default rates on subprime mortgages and declining home prices, has led to increases in actual and expected credit losses for residential mortgage-backed securities and mortgage loans. In early 2007, the credit markets began reacting to these changing factors and the prices of many securities backed by subprime mortgages began to decline. Lower volumes of transactions in certain types of collateralized securities might make it more difficult to obtain relevant market information to estimate the fair value of these financial instruments.

[2] In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS 157, which is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. This standard, which some companies early-adopted, defines fair value, establishes a framework for measuring fair value, and expands disclosures. On November 14, 2007, the FASB voted to expose for comment a one year deferral for the implementation of SFAS 157 for certain nonrecurring, nonfinancial assets and liabilities. See FASB web site at www.fasb.org.

Therefore, the practice alert describes the applicable accounting pronouncements in these areas and provides direction, in accordance with the auditing standards, for evaluating the application of GAAP.[3]

The practice alert also discusses the auditor's responsibilities, under the existing auditing standards, when using the work of specialists. The alert provides some considerations for the auditor in determining whether a specialist is needed and highlights the requirement that the auditor should evaluate assumptions used in fair value measurements developed by a company's specialist in accordance with the PCAOB standard on auditing fair value measurements. It also highlights the auditor's responsibility to evaluate the appropriateness of using the specialist's work for the purpose of financial statements prepared in conformity with GAAP.

The practice alert is organized into four sections—

- Auditing fair value measurements;
- Classification within the fair value hierarchy under SFAS 157;
- Using the work of specialists; and
- Use of a pricing service.

Auditing Fair Value Measurements

AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, applies to auditing fair value measurements and disclosures in financial statements.[4] Among other things, AU sec. 328 states that the auditor should evaluate whether the fair value measurements and disclosures in the financial statements are in conformity with GAAP. In general, for companies that had not adopted SFAS 157 before its mandatory effective date, GAAP in effect throughout 2007 provides that—

- Fair value is the amount at which an asset or liability could be bought or sold in a current transaction between willing parties, that is, other than a forced or liquidation sale;[5]
- Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available;[6]
- The estimate of fair value should consider prices for similar assets;[7] and

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[3] In order to provide guidance to auditors on auditing fair value measurements, this practice alert necessarily describes GAAP used by public companies to measure fair value. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP, rests with the Securities and Exchange Commission. Accordingly, while this staff audit practice alert describes applicable GAAP, it should not be understood as establishing or interpreting GAAP.

[4] AU secs. 342, *Auditing Accounting Estimates*, and 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, also are related to auditing fair value.

[5] See SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, paragraph 137; SFAS 133, *Accounting for Derivatives and Hedging Activities*, paragraph 540; and SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, paragraph 69.

[6] Ibid. Also, in paragraph 58 of SFAS 107, *Disclosures about Fair Value of Financial Assets* the FASB Board reiterated its belief that quoted prices, even from thin markets, provide useful information because investors and creditors regularly rely on those prices to make their decisions.

[7] See SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, paragraph 137; SFAS 133, *Accounting for Derivatives and Hedging Activities*, paragraph 540; and paragraph 69 of SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

- Valuation techniques should incorporate assumptions that market participants would use in their estimates of value.[8]

In addition, AICPA Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, requires certain disclosures, in addition to those required by other accounting standards, about estimates when certain information is known prior to the issuance of financial statements.[9]

SFAS 157 incorporates concepts similar to those in SFASs 115, *Accounting for Certain Investments in Debt and Equity Securities*, 133, *Accounting for Derivatives and Hedging Activities*, and 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. However, it also introduces concepts such as the principal and most advantageous markets and the fair value hierarchy of inputs (further discussed in this alert).[10]

In planning and performing procedures in response to the risk associated with fair value measurements, the auditor should obtain an understanding of the company's process for determining fair value measurements and disclosures, including relevant controls.[11] In addition, the auditor should, among other things—

- Evaluate whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information.[12] For example, the fact that transaction volume in a particular market is lower than in previous periods may not necessarily support an assumption that transactions in that market constituted forced or distressed sales.
- If management relies on historical financial information in the development of an assumption, consider the extent to which such reliance is justified. However, historical information might not be representative of future conditions or events.[13] For example, an auditor should evaluate whether a company's use of historical default rates, in an environment in which default rates are increasing, is justified.
- Evaluate whether the company's method for determining fair value measurements is applied consistently and if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the company.[14] For example, the relative weightings in a company's model may not be reasonable in situations where there has been a change in market conditions. In such cases, auditors should consider whether compliance with applicable accounting standards might require a change in the model.

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[8] Ibid.

[9] See SOP 94-6, paragraph .13.

[10] See SFAS 157, paragraphs 8, 22, and 23.

[11] See AU sec. 328.09.

[12] See AU sec. 328.26.

[13] See AU sec. 328.37.

[14] See AU sec. 328.19. Also, under SFAS 157, paragraph 20, a change in valuation technique or its application, is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances.

Inputs based on a company's own data may be more susceptible to preparer bias because they may not be based on observable market inputs.[15] In such cases, the auditor should be aware of the increased risk of management bias and address the related risk of material misstatement.[16]

Classification Within the Fair Value Hierarchy Under SFAS 157

Under SFAS 157, a company must determine the appropriate level in the fair value hierarchy for each fair value measurement. The fair value hierarchy in SFAS 157 prioritizes the inputs, which refer broadly to assumptions market participants would use in pricing an asset or liability, into three levels. It gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.[17] The level in the fair value hierarchy within which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices within Level 1 that are observable for the asset or liability, either directly or indirectly. A significant adjustment to a Level 2 input could result in the Level 2 measurement becoming a Level 3 measurement.
- Level 3 inputs are unobservable inputs for the asset or liability.[18]

Because there are different consequences associated with each of the three levels of the hierarchy, the auditor should be alert for circumstances in which the company may have an incentive to inappropriately classify fair value measurements within the hierarchy. For example, an asset or liability with Level 1 inputs generally must be measured using unadjusted quoted prices in an active market, while an asset or liability with Level 2 inputs is measured using observable market inputs other than quoted prices included in Level 1. Accordingly, a Level 2 measurement might allow for more discretion or judgment on the part of management than a Level 1 measurement. As another example, the required disclosures associated with Level 3 measurements are more extensive than those associated with Level 1 and Level 2 measurements.

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[15] See AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. Paragraph .39 notes that certain accounts, classes of transactions, and assertions may have high inherent risk due to a high degree of management judgment and subjectivity. They also may represent fraud risks because they are susceptible to management manipulation.

[16] AU sec 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .36, provides that the risk of material misstatement is generally greater when account balances include estimates because of the inherent subjectivity in estimating future events.

[17] See SFAS 157, paragraph 21. Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity. Unobservable inputs are those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

[18] See SFAS 157, paragraphs 22–32.

The auditor's opinion is based on, among other things, his or her judgment as to whether the financial statements and related notes are informative of matters that may affect their use, understanding, and interpretation.[19] In evaluating whether a company's disclosures are complete, accurate, and in conformity with SFAS 157, the auditor should be aware that a financial statement disclosure that is not in accordance with GAAP could be a misstatement of the financial statements.[20]

Using the Work of Specialists

Management and auditors frequently use the work of a specialist in preparing and auditing financial statements containing complex fair value measurements.

AU sec. 328 states that the auditor should consider whether to engage a specialist and use the work of that specialist as evidential matter in performing substantive tests to evaluate material financial statement assertions.[21] As part of the consideration, the auditor should evaluate whether he or she has the necessary skill and knowledge to plan and perform audit procedures related to the fair value measurement. Factors to consider include—

- Significant use of unobservable inputs;
- Complexity of the valuation technique; and
- Materiality of the fair value measurement.

AU sec. 336, *Using the Work of a Specialist*, provides direction that applies when the auditor uses the work of a specialist, whether the specialist is engaged by the company or the auditor. It states that the auditor should (a) obtain an understanding of the methods and assumptions used by the specialist, (b) make appropriate tests of data provided to the specialist, and (c) evaluate whether the specialist's findings support the related assertions in the financial statements.[22] In obtaining an understanding of the specialist's methods, the auditor should consider whether the method will result in a measurement that is in conformity with the applicable accounting standards.[23] In addition, the auditor should evaluate, in accordance with AU sec. 328, the assumptions developed by a specialist engaged or employed by management.[24]

Additionally, the auditor should evaluate the specialist's qualifications, including the specialist's experience in the type of work under consideration, and obtain an understanding of the work performed by the specialist, including the appropriateness of using the specialist's work for the intended purpose.[25] In the context of this practice alert, the intended purpose of the specialist's work is the valuation of assets and liabilities for use in financial statements prepared in conformity with GAAP.

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[19] See AU sec. 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, paragraph .04.

[20] See AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit*: Auditing Interpretations of Section 312, paragraphs .01 and .02.

[21] See AU sec. 328.20.

[22] See AU sec. 336.12.

[23] See AU secs. 328.03 and 336.09.

[24] AU sec. 328 provides that management's assumptions used in fair value measurements or disclosures include assumptions developed by a specialist engaged or employed by management. See AU sec. 328.05, footnote 2.

[25] See AU sec. 336.08–.09.

Use of a Pricing Service

If a company uses a pricing service for its fair value measurements, the auditor should determine the nature of the information provided by the pricing service. For example, the auditor should understand whether the fair value measurement was determined using quoted prices from an active market, observable inputs (such as prices for similar assets), or fair value measurements based on a model, and adjust his or her audit procedures based on the nature of the information provided by the pricing service.[26] In addition, if the price is not based on quoted prices from an active market or observable inputs (such as prices for similar assets), the auditor should obtain an understanding of the model and evaluate whether the assumptions are reasonable.[27]

There are additional factors for the auditor to consider under SFAS 157. For example, under SFAS 157, a fair value measurement assumes that the transaction occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market. The principal market is one in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity. If there is a principal market, under SFAS 157, the fair value measurement represents the price in that market even if the price in a different market is potentially more advantageous.[28]

Under SFAS 157, when a company uses a pricing service, the auditor should evaluate whether the assumptions used by the pricing service reflect the price to sell the asset or paid to transfer the liability in the principal market (or most advantageous market if the company has no principal market) of the company. If the pricing service valuation is based on actual trades or quotes, the auditor should evaluate whether those traded or quoted prices would be available to the company in the company's principal market (or most advantageous market, if the company has no principal market). For example, a pricing service might provide an amount for which a large financial institution could sell the financial instrument. However, a company that owns that financial instrument might not be able to transact in the same market as a large financial institution. If the price available to a large financial institution would not be available to the company, then that price may not be an appropriate measure of fair value under SFAS 157.

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[26] The evaluation of pricing information also is applicable to fair value measurements that a company obtains from other third parties.

[27] See AU secs. 328.05 and 336.12. In addition, see AU sec. 332.39.

[28] See FASB Statement 157, paragraph 8.

.03 Staff Audit Practice Alert No. 3

Audit Considerations in the Current Economic Environment

December 5, 2008

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Recent events in the financial markets and the current economic environment may affect companies' operations and financial reporting and, in turn, may have implications for audits of financial statements and internal control over financial reporting. Audit risks that may have been identified previously may become more significant or new risks may exist due to current events (e.g. those affecting the economy, credit and liquidity). Among other things, the current uncertainties in the market and economy may create questions about the valuation, impairment, or recoverability of certain assets and the completeness or valuation of certain liabilities reflected in financial statements.

The purpose of this staff audit practice alert is to assist auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis. While the alert highlights certain areas, it is not intended to identify all areas that might affect audit risk in the current economic environment or serve as a substitute for the relevant auditing standards. All audits of issuers must be conducted in accordance with the standards of the PCAOB.

The practice alert is organized into six sections—

- Overall audit considerations;
- Auditing fair value measurements;
- Auditing accounting estimates;
- Auditing the adequacy of disclosures;
- Auditor's consideration of a company's ability to continue as a going concern; and
- Additional audit considerations for selected financial reporting areas.

In order to provide guidance to auditors on audit considerations in the current economic environment, this practice alert necessarily describes generally

accepted accounting principles ("GAAP") used by public companies in various areas. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP, rests with the U.S. Securities and Exchange Commission ("SEC"). Accordingly, while this staff audit practice alert describes applicable GAAP, it should not be understood as establishing or interpreting GAAP.

Overall Audit Considerations

The following section describes overall audit considerations related to planning, fraud, internal controls, substantive procedures, and communications with audit committees that may be affected by recent events in the financial markets and current economic conditions.

Planning considerations

The effects of current economic conditions on a company's operations and financial reporting may affect audit planning. In planning the audit, the auditor should consider, among other things, matters affecting the industry in which the company operates, including the economic conditions.[1]

As the audit progresses, changed conditions may make it necessary to modify planned audit procedures.[2] Accordingly, the auditor may need to reassess audit risks and update his or her understanding of how current economic conditions may affect the company's financial reporting. Knowledge of these effects helps the auditor in—

- Identifying areas that may need special consideration;
- Assessing conditions under which accounting data are produced, processed, reviewed, and accumulated within the company;
- Evaluating the reasonableness of estimates, such as valuation of inventories, depreciation, allowances for doubtful accounts, and percentage of completion of long-term contracts;
- Evaluating the reasonableness of management representations;
- Making judgments about the appropriateness of the accounting principles applied and the adequacy of disclosures.[3]

Whenever the auditor has concluded that there is significant risk of material misstatement of the financial statements, the auditor should consider this conclusion in determining the nature, timing, or extent of procedures; assigning staff; or requiring appropriate levels of supervision.[4] Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of year end, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence.[5]

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[1] Paragraphs .03 and .07 of AU sec. 311, *Planning and Supervision,* and paragraph 9 of PCAOB Auditing Standard No. 5 ("AS No. 5"), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

[2] AU sec. 311.05.

[3] AU sec. 311.06.

[4] Paragraph .17 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*.

[5] Ibid.

In an audit of internal control over financial reporting, a direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention that should be devoted to that area.[6]

Fraud risk considerations

The current economic environment may also trigger certain risk factors that may affect the risk of misstatement due to fraudulent financial reporting. Examples of risk factors include—

- Incentives and pressures
  - — Financial stability or profitability is threatened by economic, industry, or company operating conditions;
  - — Excessive pressure exists for management to meet the requirements or expectations of third parties;
  - — Information available indicates management or the board of directors' personal financial situation is threatened by the company's financial performance;
  - — Excessive pressure is placed on management or operating personnel to meet financial targets set up by the board of directors or management, including sales or profitability incentive goals;
- Opportunities
  - — The nature of the industry or the company's operations provides opportunities to engage in fraudulent financial reporting;
  - — There is ineffective monitoring of management;
  - — There is a complex or unstable organizational structure;
  - — Internal control components are deficient.[7]

The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.[8] As part of the understanding of internal control sufficient to plan the audit, the auditor should evaluate whether entity programs and controls that address identified risks of material misstatement due to fraud have been suitably designed and placed in operation.[9] Also, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.[10] The auditor responds to risks of material misstatement due to fraud in the following three ways—

- A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned.[11]

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[6] AS No. 5, paragraph 11.

[7] Paragraph .85A.2 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*

[8] Paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor.*

[9] AU sec. 316.44.

[10] AU sec. 316.41.

[11] AU sec. 316.48.

For example, the knowledge, skill, and ability of personnel assigned significant engagement responsibilities should be commensurate with the auditor's assessment of the risks of material misstatement due to fraud for the engagement.[12] The auditor also should consider management's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions.[13] Further, the auditor should incorporate an element of unpredictability in the selection from year to year of auditing procedures to be performed.[14]

- A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed.[15] For example, the auditing procedures performed in response to identified risks of material misstatement due to fraud should vary depending upon the types of risks identified and the account balances, classes of transactions, and related assertions that may be affected.[16] Such procedures may involve both substantive tests and tests of the operating effectiveness of the company's programs and controls.[17]
- A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which Audit Considerations in the such override could occur.[18] For example, the auditor should examine journal entries and other adjustments for evidence of possible material misstatement due to fraud.[19] The auditor also should review accounting estimates for biases that could result in material misstatement due to fraud,[20] and evaluate the business rationale for significant unusual transactions.[21]

The auditor's assessment of the risks of material misstatement due to fraud should be ongoing throughout the audit.[22]

In an audit of internal control over financial reporting, the risk that a company's internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error.[23]

Internal control considerations

The current environment may increase audit risk and thus require additional auditor attention regarding the effective operation of internal controls. Areas in which additional attention may be required include the company's

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[12] AU sec. 316.50.
[13] Ibid.
[14] Ibid.
[15] AU sec. 316.48.
[16] AU sec. 316. 51.
[17] Ibid.
[18] AU sec. 316.48.
[19] AU sec. 316.58.
[20] AU sec. 316.63.
[21] AU sec. 316.66.
[22] AU sec. 316.68.
[23] AS No. 5, paragraph 11.

entity-level controls, such as, among other things, controls related to the control environment, and the company's risk assessment process. Additional attention also may be warranted on the controls related to certain significant accounts and disclosures and their relevant assertions, such as controls over the development of inputs and assumptions for the valuation of significant assets and liabilities; controls over the identification and review of assets for recoverability or impairment; and controls over the company's use of external specialists (for example, valuation or actuarial specialists) who assist in the determination of recorded amounts of certain assets or liabilities. In addition, some companies are responding to the current economic conditions by eliminating jobs. The loss of employees integral to the operation of internal controls may increase the risk of deficiencies in internal control over financial reporting because of, for example, lack of segregation of duties or lack of effective monitoring controls.

In an audit of internal control over financial reporting, the auditor also should evaluate whether the company's controls sufficiently address the identified risks of material misstatement due to fraud[24] and controls intended to address the risk of management override of controls.[25] Controls that might address these risks include—

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.[26]

Effect on substantive procedures

Because the current environment may increase inherent and control risks, the auditor might need to modify his or her planned substantive procedures or perform additional substantive procedures in order to reduce the level of detection risk to an acceptable level to support his or her opinion on the financial statements. Examples of modifications of planned substantive procedure include the following—

- Changing the nature of substantive tests from a less effective to a more effective procedure, such as using tests directed toward independent parties outside the company rather than tests directed toward parties or documentation within the company;
- Changing the timing of substantive tests, such as performing them at year end rather than at an interim date; and
- Changing the extent of substantive tests, such as using a larger sample size.[27]

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[24] AS No. 5, paragraph 14.

[25] AS No. 5, paragraph 14. AU secs. 316.57 to .67 describe procedures that should be performed to address the risk of management override of controls.

[26] AS No. 5, paragraph 14.

[27] Paragraph .82 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*.

Communications with audit committees

The auditor has a responsibility to communicate certain matters related to the conduct of the audit to the audit committee.[28] Some of the required communications that may be affected by current economic conditions include discussions about accounting estimates as well as the company's accounting principles.

With respect to accounting estimates, the auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.[29] The auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting.[30] The discussion should include such matters as the consistency of the company's accounting policies and their application, and the clarity and completeness of the company's financial statements, which include related disclosures.[31] The discussion also should include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.[32] Examples of items that may have such an effect include the following—

- Selection of new or changes to accounting policies;
- Estimates, judgments, and uncertainties;
- Unusual transactions; and
- Accounting policies relating to significant financial statement items, including the timing of transactions and the period in which they are recorded.[33]

While these and other communications are directed to the audit committee, the auditor is not precluded from communicating with management or other individuals within the company, who may, in the auditor's judgment, benefit from the communications.[34]

Auditing Fair Value Measurements

Certain kinds of investments such as auction rate securities, commercial paper, mortgage-backed or other asset-backed securities, alternative investments (such as hedge funds, private equity investments, funds of funds, etc.), collateralized debt obligations and other investments may present complexities in valuation because of the current conditions in the financial markets. Accordingly, difficulties surrounding the measurement of fair value and the adequacy of related disclosures have come under increased focus over the past year.

Statement of Financial Accounting Standard ("SFAS") No. 157, *Fair Value Measurements*,[35] establishes a framework for measuring fair values for financial

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[28] Paragraph .01 of AU sec. 380, *Communication With Audit Committees*.

[29] AU sec. 380.08.

[30] AU sec. 380.11.

[31] Ibid.

[32] Ibid.

[33] Ibid.

[34] AU sec. 380.02.

[35] In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") No. 157, *Fair Value Measurements*, which is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods

(continued)

reporting purposes and expands disclosures about those measurements. On September 30, 2008, the SEC's Office of the Chief Accountant and the Financial Accounting Standards Board ("FASB") staff issued *Clarifications on Fair Value Accounting* acknowledging that "the current environment has made questions surrounding the determination of fair value particularly challenging for preparers, auditors and users of financial information."[36] On October 10, 2008, the FASB issued Staff Position ("FSP") No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active,* which provides application guidance regarding—

- How the company's own assumptions (that is, expected cash flows and appropriately risk-adjusted discount rates) should be considered when measuring fair value when relevant observable inputs do not exist;
- How available observable inputs in a market that is not active should be considered when measuring fair value; and
- How the use of market quotes (for example, broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable inputs available to measure fair value.[37]

The following matters may be particularly important for auditors in considering fair value accounting estimates—

- The extent to which fair value accounting applies to various accounts;
- The choice and complexity of valuation techniques and models;
- Judgments concerning significant assumptions that may be used by others such as specialists employed or engaged by the company or the auditor;
- The availability, or lack thereof, of information or evidence and its reliability; and
- The extent of disclosure in the financial statements about measurement methods and uncertainty.

PCAOB Staff Audit Practice Alert No. 2 ("Practice Alert No. 2"), *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, remains relevant in the current environment and reminds auditors of their responsibilities with regard to—

- Auditing fair value measurements,
- Classification within the fair value hierarchy under SFAS 157,
- Using the work of specialists, and
- Use of a pricing service.[38]

(footnote continued)

within those fiscal years. The FASB deferred the implementation of SFAS No. 157 for certain nonrecurring, nonfinancial assets and liabilities for financial statements issued for fiscal years beginning after November 15, 2008 and interim periods within those fiscal years.

[36] See http://www.sec.gov/news/press/2008/2008-234.htm.

[37] Paragraph 5 of FASB Staff Position ("FSP") No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*.

[38] PCAOB Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (December 10, 2007).

In discussing the auditor's responsibilities for auditing fair value measurements, Practice Alert No. 2 refers the auditor to AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, AU sec. 336, *Using the Work of a Specialist*, and AU sec. 342, *Auditing Accounting Estimates*.

Auditing Accounting Estimates

Accounting estimates measure the effects of past business transactions or events, or the present status of an asset or liability.[39] Examples of accounting estimates include net realizable value of inventories, allowance for uncollectible accounts receivable, valuation allowance for deferred tax assets, actuarial assumptions in pension and other postretirement benefit costs, the impairment analysis and estimated useful lives of long-lived assets, restructuring accruals, and assumptions used in option pricing models for share-based payments.[40] In auditing accounting estimates, the auditor normally should consider, among other things, the company's historical experience in making past estimates as well as the auditor's experience in the industry.[41] However, changes in facts, circumstances, or a company's procedures may cause factors different from those considered in the past to become significant to the accounting estimate.[42] The significance of the recent changes in the economy and the financial markets increases the likelihood that this will be the case.

The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole.[43] In evaluating the reasonableness of accounting estimates, the auditor should obtain an understanding of how management developed the estimate.[44] Based on that understanding, the auditor should use one or a combination of the following approaches—

- Review and test the process used by management to develop the estimate;
- Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate;
- Review subsequent events or transactions occurring prior to the date of the auditor's report.[45]

The work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would be required to obtain an understanding of the process management used to develop the estimate and to test controls over all relevant assertions related to the estimate.[46]

In evaluating the reasonableness of an estimate, the auditor normally concentrates on key factors and assumptions that are—

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[39] Paragraph .02 of AU sec. 342, *Auditing Accounting Estimates*.

[40] See AU sec. 342.16 for other examples of accounting estimates.

[41] AU sec. 342.09.

[42] Ibid.

[43] AU sec. 342.04.

[44] AU sec. 342.10.

[45] Ibid.

[46] Ibid.

- Significant to the accounting estimate;
- Sensitive to variations;
- Deviations from historical patterns;
- Subjective and susceptible to misstatement and bias.[47]

When assessing audit differences between estimates best supported by the audit evidence and the estimates included in the financial statements, the auditor should consider whether such differences, even if they are individually reasonable, indicate a possible bias on the part of the company's management, in which case the audit or should reconsider the estimates taken as a whole.[48]

As part of the audit, the auditor also should perform a retrospective review of significant accounting estimates reflected in the financial statements of the prior year to determine whether management judgments and assumptions relating to the estimates indicate a possible bias on the part of management.[49] With the benefit of hindsight, a retrospective review should provide the auditor with additional information about whether there may be a possible bias on the part of management in making the current year estimates.[50]

Auditing the Adequacy of Disclosures

The current economic environment may increase the risks regarding the adequacy of disclosures, including the disclosures surrounding a company's risks and uncertainties, which in turn may warrant additional auditor attention.

The American Institute of Certified Public Accountants' Statement of Position 94-6 ("SOP 94-6"), *Disclosure of Certain Significant Risks and Uncertainties*, focuses on disclosures about risks and uncertainties, that in the near term (considered to be within one year from the date of the financial statements), could affect the amounts reported in the financial statements or the functioning of the reporting company.[51] SOP 94-6 provides that companies should make disclosures in their financial statements about the risks and uncertainties in the following areas—

- Nature of operations;
- Use of estimates in the preparation of financial statements;
- Certain significant estimates;
- Current vulnerability due to certain concentrations.[52]

The presentation of financial statements in conformity with GAAP includes adequate disclosure of material matters, related to the form, arrangement, and content of the financial statements and their appended notes.[53] The auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which he or she is aware at the time.[54] If management omits

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[47] AU sec. 342.09.

[48] AU sec. 316.63.

[49] AU sec. 316.64.

[50] Ibid.

[51] Paragraph .02 of American Institute of Certified Public Accountants' Statement of Position 94-6 ("SOP 94-6"), *Disclosure of Certain Significant Risks and Uncertainties.* Paragraph .07 of SOP 94-6 defines near term as a period of time not to exceed one year from the date of the financial statements.

[52] SOP 94-6, paragraph .08.

[53] Paragraph .02 of AU sec. 431, *Adequacy of Disclosure in Financial Statements.*

[54] Ibid.

from the financial statements, including the accompanying notes, information that is required by GAAP, the auditor should express a qualified or adverse opinion and should provide the information in his or her report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific PCAOB auditing standard.[55]

With respect to other information included in documents containing the financial statements, the auditor should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.[56] For instance, the section on management's discussion and analysis of financial condition and results of operations in Form 10-K requires discussion of liquidity, capital resources, results of operations, off-balance sheet arrangements and contractual obligations.[57] In addition, the section on controls and procedures of the Form 10-K requires discussion of management's responsibility for internal control over financial reporting and changes in internal control over financial reporting.[58] If the information in these disclosures is materially inconsistent with the financial statements, the auditor should determine whether the financial statements, the audit report, or both require revision.[59]

Auditor's Consideration of a Company's Ability to Continue as a Going Concern

In the current economic environment, some companies may face challenges in their ability to continue operating as a going concern. For instance, sources of liquidity may be strained because of reduced availability of lines/letters of credit from financial institutions or because of a violation of a debt covenant or other covenant. Additionally, companies may encounter limited access to the commercial paper markets, a decrease in valuation of collateral, difficulty restructuring loans, and delays in payment from customers.

The auditor has a responsibility to evaluate whether there is a substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.[60] The auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report.[61]

The auditor's evaluation includes considering whether the results obtained in planning, performing, and completing the audit identify conditions and events that, when considered in the aggregate, indicate there could be a substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.[62] It may be necessary to obtain additional information about such

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[55] AU sec. 431.03.

[56] Paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

[57] Regulation S-K, Item 303, *Management's Discussion and Analysis of Financial Condition and Results of Operations*.

[58] Regulation S-K, Items 308 and 308T, *Internal Control Over Financial Reporting.*

[59] AU sec. 550.04.

[60] Paragraph .02 of AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern.*

[61] Ibid.

[62] AU sec. 341.03a.

conditions and events, as well as the appropriate evidential matter to support information that mitigates the auditor's doubt.[63] Conditions or events that, when considered in the aggregate, indicate there could be substantial doubt about the company's ability to continue as a going concern for a reasonable period of time include—

- *Negative trends*—for example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, adverse key financial ratios;
- *Other indications of possible financial difficulties*—for example, default on loan or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, restructuring of debt, noncompliance with statutory capital requirements, need to seek new sources or methods of financing or to dispose of substantial assets;
- *Internal matters*—for example, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, need to significantly revise operations;
- *External matters that have occurred*—for example, legal proceedings, legislation, or similar matters that might jeopardize a company's ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; uninsured or underinsured catastrophe such as a drought, earthquake, or flood.[64]

If the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the auditor should obtain information about management's plans that are intended to mitigate the effect of such conditions or events, and assess the likelihood that such plans can be effectively implemented.[65] The auditor's considerations relating to management plans may include the following—

- Plans to dispose of assets;
- Plans to borrow money or restructure debt;
- Plans to reduce or delay expenditures;
- Plans to increase ownership equity.[66]

Such considerations also may include the effect of federal assistance or participation in a federal program.

If, after considering identified conditions and events and management's plans, the auditor concludes there is substantial doubt, he or she should consider the possible effects on the financial statements and the adequacy of disclosure about the company's inability to continue as a going concern for a reasonable period of time, and include an explanatory paragraph in the audit report to reflect this conclusion.[67] If the auditor concludes that substantial doubt is alleviated, the auditor should consider the need for disclosure of the principal conditions

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[63] Ibid.

[64] AU sec. 341.06.

[65] AU sec. 341.03b.

[66] AU sec. 341.07.

[67] AU secs. 341.10 and 341.12.

and events that initially caused the auditor to believe there was substantial doubt.[68]

Additional Audit Considerations for Selected Financial Reporting Areas

The following discussion provides auditors with information on selected financial reporting areas that may be affected by the current economic environment. The auditor should give consideration to elevated risks related to the current economic environment and adjust his or her audit procedures as appropriate. This list is not intended to be all inclusive.

- Consolidation
- Contingencies and guarantees
- Credit derivatives
- Debt obligations
- Deferred tax assets
- Derivatives (other than credit derivatives)
- Goodwill, intangible assets and other long-lived assets
- Inventory
- Other-than-temporary impairment
- Pension and other postretirement benefits
- Receivables
- Restructuring
- Revenue recognition
- Share-based payments

Consolidation

As a result of the economic environment, some companies have provided financial support or guarantees, or have taken other actions that may cause them to have a variable interest in an entity or to have increased their exposure to the entity, and, therefore, cause them to consider or reconsider whether the entity is a variable interest entity and if so whether they are its primary beneficiary.[69] Such commitments to provide financial support or guarantees might be found in various contractual arrangements, such as leasing arrangements, supply contracts, service contracts or derivative contracts.

FASB Interpretation ("FIN") No. 46(R) (as amended), *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*, addresses consolidation by the primary beneficiary of variable interest entities. On November 21, 2008, the FASB announced plans to issue final FSP FAS 140-4 and FIN 46(R)-8, *Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities,* by December 15, 2008, which will increase disclosure requirements for public companies for reporting periods that end after December 15, 2008.[70]

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[68] AU sec. 341.11.

[69] Paragraphs 7 and 15 of FASB Interpretation ("FIN") No. 46(R) (as amended), *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*.

[70] See http://www.fasb.org/news/nr112108.shtml.

Contingencies and guarantees

Recent events in the credit markets may expose companies to additional contingencies and guarantees, which could increase the risk of unidentified or undisclosed contingencies related to, for example—

- Pending or threatened litigation;
- Asserted or unasserted claims and assessments;
- Guarantees of indebtedness of others;
- Guarantees to repurchase receivables or property previously sold or otherwise assigned;
- Violations of laws and regulations;
- Guarantees of contractual performance of others; and
- Outstanding purchase commitments at prices in excess of market values.

The audit normally includes procedures that might identify litigation, claims, and assessments, among other things.[71] Examples of such procedures include the following—

- Reading minutes of meetings of stockholders, directors, and appropriate committees held during and subsequent to the period being audited;
- Reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies, and similar documents;
- Obtaining information concerning guarantees from bank confirmation forms;
- Inspecting other documents for possible guarantees by the client.[72]

Credit derivatives

The downturn in the credit markets can have a significant effect on the fair value of a company's credit derivatives. A credit derivative is a derivative instrument whose value derives from the credit risk on an underlying bond, loan or financial asset. The credit risk is on an entity other than the counterparty to the transaction.[73] This entity is known as a reference entity, which incurred the debt.[74]

Credit derivatives are bilateral contracts between the buyer and seller under which the seller sells to the buyer protection against the credit risk of the reference entity.[75] Credit derivatives may be valued through the use of internally developed models or by pricing services. The assumptions used in models can

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[71] Paragraph .07 of AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments*. AU sec. 337.08 indicates that a letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments.

[72] AU sec. 337.07.

[73] Satyajit Das, *Credit Derivatives: CDOs and Structured Credit Products*, (Singapore: John Wiley and Sons (Asia) Pte Ltd, 2005, Third Edition).

[74] Edmund Parker, "Credit Derivatives," *PLC Finance* (http://www.mayerbrown.com/london/article.asp?id=4234&nid=1575).

[75] Ibid.

be highly subjective, sensitive, and complex. A slight difference in assumptions could result in a significant change in the valuation of the derivative.

One factor that affects the fair value of credit derivatives is a decline in the credit quality of the reference entity. As a result of the deterioration in credit derivative positions insured by sellers of credit derivatives, some sellers have been required to post significant amounts of additional collateral. A seller also may be required to post additional collateral based on the deterioration of its own credit standing (regardless of changes in value of the written credit derivatives) to protect the buyer from default by the seller. In addition, the fair value of the asset included in the buyer's financial statements is affected by both the credit rating of the seller of the credit derivative (the counterparty) and the credit rating of the reference entity. The credit risk of the seller may affect the fair value of the liability in the seller's financial statements. In response to concerns from financial statement users and others that the current disclosure requirements for derivative instruments and certain guarantees did not adequately address the potential adverse effects of changes in the credit risk on the financial position, financial performance, and cash flows of the sellers of credit derivatives and certain guarantees, the FASB issued a staff position aimed at improving such disclosures.[76]

The auditor should obtain evidence supporting management's assertions about the fair value of derivatives measured or disclosed at fair value.[77] In addition, the auditor should evaluate whether the presentation and disclosure of derivatives are in conformity with GAAP.[78]

In addition to valuation and presentation and disclosure, other considerations relate to existence and completeness. In March 2008, the President's Working Group on Financial Markets noted "[w]hile the infrastructure of the financial markets generally has coped quite well with heightened price volatility and surging trading volumes, there have been issues with the accuracy and timeliness of trade data transmissions, the timeliness of resolutions of trade matching errors, documentation and cash settlement, electronic post-trade processing, backlogs, integrated processing, and reconciliation and valuation."[79] Sellers and buyers of credit derivatives may have made trades which may not be properly reflected in the financial statements. AU sec. 332 provides examples of substantive procedures auditors may perform to obtain evidence about whether all derivatives have been properly identified and appropriately included in the financial statements.[80]

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[76] Paragraph 1 of FSP No. FAS 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161* (September 12, 2008).

[77] Paragraph .35 of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. AU secs. 332.35 to .48 provide further direction on auditing valuations based on fair value.

[78] AU sec. 332.49. AU secs. 332.49 to .51 provide further direction on auditing presentation and disclosure of derivatives.

[79] See pages 18 to 19 of the Policy Statement on Financial Market Developments by The President's Working Group on Financial Markets (March 2008) (http://www.treas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf). In June 2008, the Federal Reserve Bank of New York noted that "[s]tarting in September 2005, industry participants implemented a number of initiatives to improve the operational performance and infrastructure of the over-the-counter markets" and that market participants and regulators agreed on an "agenda for bringing about further improvements in the OTC derivatives market infrastructure." Federal Reserve Bank of New York, "Statement Regarding June 9 Meeting on Over-the-Counter Derivatives" (June 9, 2008), (http://www.newyorkfed.org/newsevents/news/markets/2008/ma080609.html).

[80] AU secs. 332.21 to .24.

Debt obligations

Companies may find it more difficult to refinance debt or it may take longer to arrange new financing in the current business environment, and compliance with debt covenants may be more challenging. Circumstances such as the following can affect the risks of material misstatement and the necessary audit procedures regarding debt obligations—

- Violations of existing debt covenants;
- Proper classification between short-term and long-term debt;
- The existence of cross default provisions, such that a violation of a covenant on one loan affects compliance with covenants for another loan;
- Exchange of debt or modifications to the terms of outstanding debt agreements;
- Concessions granted by lenders, including those that constitute a troubled debt restructuring;
- Subjective acceleration clauses;
- Embedded derivatives.

Deferred tax assets

Under current economic conditions, companies may need to record valuation allowances for their deferred tax assets. Deferred tax assets are required to be reduced "by a valuation allowance if, based on the weight of available evidence, it is *more likely than not* (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized."[81]

Evaluating the need for and amount of a valuation allowance for deferred tax assets requires consideration of "all available evidence, both positive and negative"[82] to determine whether all or some portion of the deferred tax assets will not be realized. SFAS No. 109, *Accounting for Income Taxes*, provides that the more negative evidence that exists (a) the more positive evidence is necessary and (b) the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset.[83]

In addition, SFAS No. 109 states that "information about an enterprise's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years. Sometimes, however, historical information may not be available (for example, start-up operations) or it may not be as relevant (for example, if there has been a significant, recent change in circumstances) and special attention is required."[84]

Future realization of a deferred tax asset "ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law."[85] SFAS No. 109 states that "the weight given to the potential

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[81] Paragraph 17e of SFAS No. 109 (as amended), *Accounting for Income Taxes*.

[82] SFAS No. 109, paragraph 20.

[83] SFAS No. 109, paragraph 25.

[84] SFAS No. 109, paragraph 20.

[85] SFAS No.109, paragraph 21.

effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified."[86]

In addition, FIN No. 48 (as amended), *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109*, defines a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in a company's financial statements.[87] The interpretation also provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.[88]

Derivatives (other than credit derivatives)

The current environment may have a significant effect on the fair value of a company's derivative contracts. In addition, the ability for a company to use hedge accounting, including its ability to apply the short-cut method, may be affected because of the company's or the counterparty's creditworthiness.[89] Hedge accounting also may be affected because changes in the fair value of the derivative may be attributable to a risk other than the risk that is being hedged, such as company or counterparty creditworthiness.[90]

Auditors should obtain evidence supporting management's assertion about the fair value of derivatives measured or disclosed at fair value.[91] External factors, such as credit and market risk, may affect the valuation of derivatives. Credit or default risk exposes the company to the risk of loss as a result of the counterparty to a derivative failing to meet its obligation. Alternatively, the credit risk of the company may affect the fair value of the derivative when the derivative is in a liability position. Market risk exposes the company to the risk of loss from adverse changes in market factors that affect the fair value of a derivative, such as interest rates and foreign exchange rates. In order for a company to use hedge accounting, GAAP requires that management have an expectation that the hedging relationship will be highly effective at inception and on an ongoing basis.[92] Counterparty default risk may affect hedge accounting as GAAP requires that consideration be given to the likelihood that the counterparty will comply with the contractual terms of the derivative contract.[93] If the likelihood that the counterparty will not default ceases to be probable, the company would be unable to conclude that a cash flow hedging relationship is expected to be highly effective in achieving offsetting cash flows.[94] Additionally, a change in the creditworthiness of the derivative's counterparty in a fair value hedge would affect the assessment of whether the relationship qualifies for hedge accounting and amount of ineffectiveness recognized in earnings under

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[86] SFAS No.109, paragraph 25.

[87] Paragraph 2 of FIN No. 48 (as amended), *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109*.

[88] Ibid.

[89] FASB Staff Implementation Guidance: Guide to Implementation of Statement 133 on Accounting for Derivative Instruments and Hedging Activities, Issue G10 ("DIG Issue G10"), *Cash Flow Hedges: Need to Consider Possibility of Default by the Counterparty to the Hedging Derivative*.

[90] Paragraphs 20 and 28 of SFAS No. 133 (as amended), *Accounting for Derivative Instruments and Hedging Activities*, discuss the risks that are being hedged for a fair value and a cash flow hedge, respectively. Paragraphs 25 and 29 of SFAS No. 133 indicate when to discontinue hedge accounting for a fair value and cash flow hedge, respectively.

[91] AU sec. 332.35.

[92] SFAS No. 133, paragraphs 20b and 28b.

[93] DIG Issue G10.

[94] Ibid.

fair value hedge accounting.[95] Under SFAS No. 133, hedge accounting ceases when a hedge is no longer highly effective on an ongoing basis.[96]

When assessing hedge accounting, auditors should gather evidential matter—

- To determine whether management complied with the hedge accounting requirements of GAAP, including designation and documentation requirements.[97]
- To support management's expectation at the inception of the hedge that the hedging relationship will be highly effective and its periodic assessment of the ongoing effectiveness of the hedging relationship as required by GAAP.[98]
- Supporting the recorded change, for a fair value hedge, in the hedged item's fair value that is attributable to the hedged risk.[99]

In addition, for a cash flow hedge of a forecasted transaction, the auditor should evaluate management's determination of whether a forecasted transaction is probable.[100]

Goodwill, intangible assets and other long-lived assets

Market conditions during an economic downturn may result in an impairment of goodwill, other indefinite-lived intangible assets and other long-lived assets. Goodwill and indefinite-lived intangible assets "shall be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired."[101] Similarly, SFAS No. 144 (as amended), *Accounting for the Impairment or Disposal of Long-Lived Assets*, states that "A long-lived asset (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable."[102] The following are examples of such events and changes in circumstances—

- A significant decrease in the market price of a long-lived asset (asset group);
- A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition;
- A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator;
- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group);

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[95] Ibid.

[96] SFAS No. 133, paragraph 67.

[97] AU sec. 332.53.

[98] Ibid.

[99] AU sec. 332.54.

[100] AU sec. 332.55.

[101] Paragraph 17 of SFAS No. 142 (as amended), *Goodwill and Other Intangible Assets.*

[102] Paragraph 8 of SFAS No. 144 (as amended), *Accounting for the Impairment or Disposal of Long-Lived Assets.*

- A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group);
- A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. The term more likely than not refers to a level of likelihood that is more than 50 percent.[103]

Goodwill of a reporting unit shall be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount.[104] Examples of such events or circumstances include—

- A significant adverse change in legal factors or in the business climate;
- An adverse action or assessment by a regulator;
- Unanticipated competition;
- A loss of key personnel;
- A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of;
- The testing for recoverability under SFAS No. 144 of a significant asset group within a reporting unit;
- Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.[105]

In addition to valuation, companies may need to reassess the useful life of indefinite-lived intangible assets and other long-lived assets. SFAS No. 142 (as amended), *Goodwill and Other Intangible Assets,* requires companies to "evaluate the remaining useful life of an intangible asset that is not being amortized each reporting period to determine whether events and circumstances continue to support an indefinite useful life."[106] In addition, when other long-lived assets (asset group) are tested for recoverability, companies also may need to review depreciation estimates and methods.[107] Under SFAS No. 144, any revision to the remaining useful life of a longlived asset resulting from that review also shall be considered in developing estimates of future cash flows used to test the asset (asset group) for recoverability.[108]

Inventory

Current market conditions and the effect on consumer spending may result in excess or obsolete inventory or inventory with carrying amounts in excess of market values. Inventory is required to be stated at the lower of cost or

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[103] Ibid.
[104] SFAS No. 142, paragraph 28.
[105] Ibid.
[106] SFAS No. 142, paragraph 16.
[107] SFAS No. 144, paragraph 9.
[108] Ibid.

market.[109] The following are examples of conditions related to the current environment that might affect the risk of material misstatement of inventory valuation and the necessary audit procedures—

- An increase in inventory balances in relation to sales levels, a reduction in inventory turnover, and the aging of inventory may indicate excess or obsolete inventory balances that are not recoverable.
- Declining prices may indicate the carrying amount of inventory is in excess of market value. Accounting Research Bulletin ("ARB") No. 43 (as amended), *Inventory Pricing* (chapter 4), requires that a loss be recognized in the current period "whenever the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes."[110]

In addition, losses on firm, uncancelable, and unhedged commitments to purchase inventory should be measured in the same way as are inventory losses and, if material, should be recognized in the accounts in the current period and separately disclosed in the income statement.[111]

Other-than-temporary impairment

Many debt and equity securities have experienced significant declines in fair value. These declines in fair value may raise questions about whether such declines are other than temporary. The auditor should evaluate management's conclusion about the need to recognize in earnings an impairment loss for a decline in fair value that is other than temporary.[112]

In accordance with SFAS No. 115 (as amended), *Accounting for Certain Investments in Debt and Equity Securities*, a charge to earnings should be made for impairment that is "other than temporary" in held-to-maturity and available-for-sale securities.[113] SEC Staff Accounting Bulletin ("SAB") No. 59, *Accounting for Noncurrent Marketable Equity Securities*, also provides the SEC staff's view and indicates that "other than temporary" should not be interpreted to mean "permanent." SAB No. 59 provides examples of factors which, individually or in combinations, may indicate that a decline is other than temporary and that a write-down of the carrying value is required, including—

- The length of the time and the extent to which the market value has been less than cost;
- The financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential; or
- The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

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[109] Accounting Research Bulletin ("ARB") No. 43 (as amended), *Inventory Pricing*, chapter 4.

[110] ARB No. 43, chapter 4, paragraph 8.

[111] ARB No. 43, chapter 4, paragraph 17.

[112] AU sec. 332.46.

[113] Paragraph 16 of SFAS No. 115 (as amended), *Accounting for Certain Investments in Debt and Equity Securities.*

SAB No. 59 further provides that "[u]nless evidence exists to support a realizable value equal to or greater than the carrying value of the investment, a write-down accounted for as a realized loss should be recorded."

Additionally, under FASB Emerging Issues Task Force No. 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets,* certain beneficial interests should be written down to fair value through earnings if the security has declined below its cost and there has been an adverse change in the estimated cash flows based on a holder's best estimate of cash flows that a market participant would use in determining the fair value of the beneficial interest.[114]

Pension and other postretirement benefits ("OPEB")

Increased credit risk and reduced liquidity in the current economic environment can have a significant effect on the fair value of plan assets as well as the assumptions used to measure the pension and OPEB obligation. Companies that sponsor pension and OPEB plans are required to recognize the funded status of these plans in the statement of financial position.[115] The funded status is measured as the difference between the fair value of plan assets and the benefit obligation.[116] SFAS No. 87 (as amended), *Employers' Accounting for Pensions*, and SFAS No. 106 (as amended), *Employers' Accounting for Postretirement Benefits Other Than Pensions*, generally require that plan investments, whether equity or debt securities, real estate or other, be measured at fair value as of the measurement date.[117] Therefore, the measurement requirements of SFAS No. 157 apply to defined-benefit postretirement plan assets. Several assumptions are relevant to determining a company's pension and OPEB obligation, such as discount rate, expected rate of return on plan assets, and rate of compensation increase. Significant declines in the stock market may adversely affect the fair value of the plan assets, and companies may need to consider recent shifts in the market when developing the expected rate of return on plan assets. Changes in fair value of plan assets affect the funded status of the plan.[118] Deviations from the expected rate of return on plan assets affect a company's pension or OPEB expenses in future periods,[119] unless gains and losses are recognized immediately.[120]

Receivables

In the current economic environment, companies may face a heightened risk of non-collection of receivables. Evidence of this risk might be noted in an increase

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[114] Paragraph 12b of FASB Emerging Issues Task Force No. 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets.*

[115] Paragraph 1 of SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R).*

[116] SFAS No. 158, paragraph 4a.

[117] Paragraph 49 of SFAS No. 87 (as amended), *Employers' Accounting for Pensions* and paragraph 65 of SFAS No. 106 (as amended), *Employers' Accounting for Postretirement Benefits Other Than Pensions*.

[118] SFAS No. 87, paragraph 35 and SFAS No. 106, paragraph 44A.

[119] SFAS No. 87, paragraph 34 and SFAS No. 106, paragraph 62.

[120] SFAS No. 87, paragraph 32 and SFAS No. 106, paragraph 59.

in days sales outstanding, the aging of receivables, or the amount of delinquent receivables.[121]

In addition for loans receivable, evidence of this risk might be rising loan delinquency and defaults and decreasing secondary market liquidity.[122] These situations can affect the risk of material misstatement in the valuation of a company's receivables and the auditor's evaluation of management's estimate of the allowance.

Restructuring

Market events and their effect on liquidity have caused many companies to take actions such as restructuring to reduce costs. SFAS No. 146 (as amended), *Accounting for Costs Associated with Exit or Disposal Activities*, addresses financial accounting and reporting for costs associated with exit or disposal activities.[123] The risks of material misstatement may relate to recording costs in the improper period, incorrect measurement or presentation of restructuring liabilities and costs, or inadequate disclosures. Misstatements could result in understatement or overstatement of restructuring liabilities and costs.

Revenue recognition

In the current economic environment, companies may be faced with increased pressure to meet revenue targets and analysts' expectations. These pressures may cause companies to change business practices, which could affect the amount and timing of revenue recognition. Examples of business practices that could affect revenue recognition and the necessary audit procedures include, among other things, rights of return, bill-and-hold arrangements, change in payment terms, side agreements, and consignment arrangements. Also, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.[124]

Share-based payments

Current market conditions have resulted in volatile stock prices for many companies. As a result, some companies may consider modifying share-based payment awards. In addition, the changing economic environment may affect the assumptions used when valuing such awards.

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[121] Scott Malone, "Corporate America Taking Longer to Collect: Study" (August 24, 2008), (http://www.reuters.com/article/reutersEdge/idUSN2745047620080827), noted that it is taking companies longer to collect from their customers.

[122] SFAS No. 114 (as amended), *Accounting by Creditors for Impairment of a Loan- an amendment of FASB Statements no. 5 and 15*, addresses the accounting by creditors for impairment of a loan by specifying how allowances for credit losses related to certain loans should be determined.

[123] As described in paragraph 2a of SFAS No. 146 (as amended), *Accounting for Costs Associated with Exit or Disposal Activities,* SFAS No. 146 does not change the accounting for termination benefits, including one-time termination benefits granted in the form of an enhancement to an ongoing benefit arrangement, covered by SFAS No. 87, SFAS No. 88 (as amended), *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, SFAS No. 106, and SFAS No. 112 (as amended), *Employers' Accounting for Postemployment Benefits—an amendment of FASB Statements No. 5 and 43*. FSP No. FAS 146-1 (as amended), *Determining Whether a One-Time Termination Benefit Offered in Connection with an Exit or Disposal Activity Is, in Substance, an Enhancement to an Ongoing Benefit Arrangement*, provides guidance on when additional termination benefits offered in connection with an exit or disposal activity are considered, in substance, enhancements to an ongoing benefit arrangement and, therefore, subject to the provisions SFAS Nos. 87, 88, 106 and 112. In addition, SFAS No. 144 addresses accounting for long-lived assets and disposal groups to be disposed of, including components of a company that are discontinued operations.

[124] AU 316.41.

The valuation of share-based payment awards under an option-pricing model includes significant estimates, such as expected term, pre-vesting forfeiture rate and the expected volatility of the underlying stock price. For new grants of awards, companies may need to revise these and other inputs to reflect current expectations. For example, expected volatility in an option-pricing model may be affected by recent volatility in the markets. Assumptions used in the option pricing model affect the value of the award and, consequently, the compensation expense that is recognized in the financial statements.

Modifications of share-based payment awards may result in the recognition of incremental compensation cost. Incremental compensation cost is measured as the excess, if any, of the fair value of the modified award over the fair value of the original award immediately before its terms are modified.[125]

PCAOB Staff Questions and Answers ("Q&A"), *Auditing the Fair Value of Share Options Granted to Employees*, remains relevant in the current environment and reminds auditors of their responsibilities for auditing share-based payments including consideration of—

- The company's process,
- Risk factors,
- Model selection,
- Assumptions used in option-pricing models,
- Validation of data and the option-pricing model,
- Role of specialists.[126]

In discussing the auditor's responsibilities for auditing the fair value of share options granted to employees, the Q&A refers the auditor to AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, AU sec. 336, *Using the Work of a Specialist*, and AU sec. 342, *Auditing Accounting Estimates*.

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[125] Paragraph 51 of SFAS No. 123(R) (as amended), *Share-Based Payment*.

[126] PCAOB Staff Questions and Answers, *Auditing the Fair Value of Share Options Granted to Employees* (October 17, 2006).

.04 Staff Audit Practice Alert No. 4

Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments

April 21, 2009

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

On April 9, 2009, the Financial Accounting Standards Board ("FASB") issued three FASB Staff Positions ("FSP" or, collectively, "the FSPs"):

- FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* ("FSP FAS 157-4")
- FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other- Than-Temporary Impairments* ("FSP FAS 115-2")
- FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* ("FSP FAS 107-1")[1]

The objectives of these FSPs are to: (1) provide "additional guidance for estimating fair value in accordance with FASB Statement No. 157, *Fair Value Measurements*, when the volume and level of activity for the asset or liability have significantly decreased" including "guidance on identifying circumstances that indicate a transaction is not orderly,"[2] (2) amend "the other-than-temporary impairment guidance in U.S. GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial

[1] The respective FSPs are available at:

— http://www.fasb.org/pdf/fsp_fas157-4.pdf
— http://www.fasb.org/pdf/fsp_fas115-2andfas124-2.pdf
— http://www.fasb.org/pdf/fsp_fas107-1andapb28-1.pdf

[2] FSP FAS 157-4, paragraph 1.

statements,"[3] and (3) "require disclosures about fair value of financial instruments for interim reporting periods for publicly traded companies as well as in annual financial statements."[4]

The purpose of this staff audit practice alert is to inform auditors about potential implications of the FSPs on reviews of interim financial information and annual audits. This alert addresses the following topics: (1) reviews of interim financial information ("reviews"); (2) audits of financial statements, including integrated audits; (3) disclosures; and (4) auditor reporting considerations. While this alert highlights certain areas, it is not intended to serve as a substitute for the relevant auditing standards.

In considering the effects of the FSPs on their audits and reviews, auditors should be aware that some PCAOB standards include descriptions of accounting requirements that are no longer current. The accounting standards set by the FASB are recognized by the U.S. Securities and Exchange Commission ("SEC") as generally accepted.[5] Auditors should look to those standards and to the requirements of the SEC,[6] rather than the standards of the PCAOB, for current accounting requirements and disregard descriptions of accounting requirements in PCAOB standards that are inconsistent with the FSPs. The PCAOB has a project on its standards-setting agenda to address the auditing standards related to auditing accounting estimates and auditing fair value measurements. In connection with this project, the PCAOB is planning to remove descriptions of accounting requirements from these standards. In general, as the PCAOB replaces or substantively revises its interim standards, it will continue to remove descriptions of accounting requirements from those auditing standards.

Reviews of Interim Financial Information

The objective of a review is to provide the auditor with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles ("GAAP"). A review differs significantly from an audit and consists principally of performing analytical procedures and making inquiries of persons responsible for financial and accounting matters.[7] A review does not provide a basis for expressing an opinion about whether the financial statements are presented fairly, in all material respects, in conformity with GAAP.[8] For an audit, PCAOB standards require that the auditor plan and

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[3] FSP FAS 115-2, paragraph 2. This FSP does not amend existing recognition and measurement guidance related to other-than-temporary impairment of equity securities. On April 14, 2009, the SEC's staff released Staff Accounting Bulletin ("SAB") No. 111, *Other Than Temporary Impairment of Certain Investments in Equity Securities*, which amends SAB Topic 5.M. SAB Topic 5.M. now excludes debt securities from its scope while maintaining the SEC staff's views related to equity securities.

[4] FSP FAS 107-1, paragraph 1.

[5] SEC, *Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter*, Exchange Act Release No. 34-47743 (April 25, 2003). The PCAOB has no authority to prescribe the form or content of an issuer's financial statements. Accordingly, while this staff audit practice alert describes applicable generally accepted accounting principles ("GAAP"), it does not establish or interpret GAAP.

[6] Auditors should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company. See AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.*

[7] Paragraph .07 of AU sec. 722, *Interim Financial Information* ("AU sec. 722").

[8] Ibid.

perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.[9]

As part of the review, the auditor should, among other things, make inquiries of members of management who have responsibility for financial and accounting matters. If relevant to the company, the auditor should include in these inquiries questions about the implementation of the FSPs.[10]

The auditor also should determine whether any matters described in AU sec. 380, *Communication With Audit Committees* ("AU sec. 380"), as they relate to the interim financial information, have been identified.[11] If such matters have been identified, the auditor should communicate those matters to the audit committee or be satisfied, through discussion with the audit committee, that management has communicated such matters to the audit committee.[12] Matters to be communicated include: a change in a significant accounting policy affecting the interim financial information; accounting estimates and management's judgments about those accounting estimates; processes management uses to formulate sensitive accounting estimates; and the auditor's judgment about the quality, not just the acceptability, of the company's accounting policies.[13] Depending upon the circumstances, the implementation of the FSPs may present matters that should be communicated to the audit committee.

Audits of Financial Statements, Including Integrated Audits

FSP FAS 157-4 provides additional guidance for estimating fair value when the volume and level of activity for an asset or liability have significantly decreased.[14] In performing procedures under AU sec. 328, *Auditing Fair Value Measurements and Disclosures* ("AU sec. 328"), the auditor is required to, among other things, obtain an understanding of the company's process for determining fair value measurements and disclosures and of the relevant controls sufficient to assess the risk of material misstatement, and to plan the nature, timing, and extent of the audit procedures.[15] Based on the auditor's assessment of the risk of material misstatement, the auditor should test the entity's fair value measurements and disclosures.[16] Because of the wide range of possible fair value measurements, from relatively simple to complex, and the varying levels of risk of material misstatement associated with the process for determining fair values, the auditor's planned audit procedures can vary significantly in nature, timing, and extent.[17] The auditor's substantive tests of the fair value measurements may involve (a) testing management's significant assumptions, the valuation model, and the underlying data, (b) developing independent fair value estimates for corroborative purposes, or (c) reviewing subsequent events and transactions.[18]

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[9] Paragraph .08 of AU sec. 508, *Reports on Audited Financial Statements*. An audit includes, among other things, examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.

[10] AU sec. 722.18(c).

[11] AU sec. 722.34.

[12] Ibid.

[13] AU secs. 380.07-.08, AU sec. 380.11, and AU sec. 722.34.

[14] FSP FAS 157-4, paragraphs 12-16.

[15] AU secs. 328.09 and 328.13.

[16] AU sec. 328.23.

[17] Ibid.

[18] Ibid.

FSP FAS 115-2 amends the guidance for recognizing an other-than-temporary impairment ("OTTI") for a debt security.[19] The auditor is required to evaluate a company's conclusions about the need to recognize an impairment loss.[20] When a company has recognized an impairment loss, the auditor should gather evidence supporting the amount of the impairment adjustment recorded and determine whether the company has appropriately followed GAAP.[21] In certain circumstances, a company is required to separate the amount of the OTTI representing credit losses (as defined by FSP FAS 115-2) and the amount representing all other factors.[22] In those situations, the auditor's objective is to obtain sufficient competent evidential matter to provide reasonable assurance that these estimates are reasonable in the circumstances and that they are presented and disclosed in conformity with GAAP.[23] In evaluating reasonableness, the auditor should obtain an understanding of how the company developed the estimates.[24] In addition, the auditor should discuss an accounting change due to FSP FAS 115-2 and other related topics (as described in the previous section related to interim financial information), with the audit committee in connection with the audit of the financial statements, including integrated audits.[25]

Disclosures

The FSPs require additional disclosures regarding fair value measurements and OTTI. For example (1) FSP FAS 157-4 requires a company to disclose changes in valuation techniques and related inputs for fair value measurements in interim and annual periods and to provide additional disclosures under Statement No. 157, *Fair Value Measurements*[26] and (2) FSP FAS 115-2 requires a company to disclose information that enables users to understand the reasons that a portion of OTTI was not recognized in earnings and the methodology and significant inputs used to calculate the portion of OTTI that was recognized in earnings.[27] The auditor should evaluate whether the financial statement disclosures are in conformity with the FSPs.[28]

In addition, the auditor should read the other information accompanying the interim and annual financial statements contained in reports filed with the SEC.[29] For example, the Management's Discussion and Analysis of Financial Condition and Results of Operations section of annual reports and other filings might include discussions regarding fair value measurements and OTTI.[30] The

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[19] FSP FAS 115-2, paragraph 7.

[20] Paragraph .48 of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

[21] Ibid.

[22] FSP FAS 115-2, paragraphs 29-30.

[23] Paragraph .07 of AU sec. 342, *Auditing Accounting Estimates*.

[24] AU sec. 342.10.

[25] AU secs. 380.07 and 380.11. Also, Section 10A(k) of the Securities and Exchange Act of 1934 requires the auditor to communicate certain matters to the audit committee.

[26] FSP FAS 157-4, paragraph 20.

[27] FSP FAS 115-2, paragraph 38.

[28] The auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which the auditor is aware at the time. See paragraph .02 of AU sec. 431, *Adequacy of Disclosure in Financial Statements*.

[29] AU sec. 722.18(f) and paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements* ("AU sec. 550").

[30] For example, see the discussion of critical accounting policies and critical accounting estimates, respectively, in SEC Release Nos. 33-8040, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies* (December 12, 2001) and 33-8350, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations* (December 29, 2003).

auditor should consider whether that information or the manner of its presentation is materially inconsistent with the financial statements. If the auditor concludes that there is a material inconsistency, or becomes aware of information that he or she believes is a material misstatement of fact, the auditor should determine if the financial statements, the audit report, or both require revision. If the auditor concludes that the financial statements or audit report do not require revision, the auditor should request the company to revise the other information.[31]

Auditor Reporting Considerations

FSP FAS 157-4 states that revisions resulting from a change in the valuation technique or its application are to be accounted for as a change in accounting estimate. In the period of adoption, entities are required to disclose a change, if any, in valuation technique and related inputs and quantify the total effect, if practicable, by major category.[32] In addition, FSP FAS 115-2 requires the company to recognize the cumulative effect of initially applying the FSP as an adjustment to the opening balance of retained earnings, as of the beginning of the period in which FSP FAS 115-2 is adopted, with a corresponding adjustment to accumulated other comprehensive income.[33]

The auditor should evaluate whether the company's accounting for and disclosure of the changes are in accordance with the FSPs. To identify consistency matters that might affect the auditor's report, the auditor should evaluate whether the comparability of the financial statements between periods has been materially affected by changes in accounting principles. A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.[34]

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[31] AU secs. 550.04-.05.

[32] FSP FAS 157-4, paragraph 22.

[33] FSP FAS 115-2, paragraph 45.

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

.05 Staff Audit Practice Alert No. 5

Auditor Considerations Regarding Significant Unusual Transactions

April 7, 2010

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

During the course of an audit, the auditor may become aware of significant transactions 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 ("significant unusual transactions").[1] Significant unusual transactions, especially those close to period end that pose difficult "substance over form" questions, can provide opportunities for companies to engage in fraudulent financial reporting.[2] Further, the auditor's evaluation of whether the company's financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, includes the consideration of the financial statement presentation and disclosure of significant unusual transactions.[3]

The auditor should gain an understanding of the business rationale or such transactions and whether that rationale (or the lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or conceal a misappropriation of assets.[4] The audit engagement team might consult with individuals having appropriate levels of knowledge, competence, and judgment regarding significant unusual transactions.[5] Such consultations regarding significant unusual transactions should occur in accordance with the firm's policies and procedures. The auditor should determine that the audit committee is informed about the methods used to account for significant

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

[2] AU sec. 316.85.

[3] Paragraph .04 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, notes financial statements are materially misstated when they contain misstatements whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly, in all material respects, in conformity with generally accepted accounting principles.

[4] AU sec. 316.66.

[5] Paragraph .19 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

unusual transactions.[6] In addition, the engagement quality reviewer cannot provide concurring approval of issuance if he or she is aware of a significant engagement deficiency, including those regarding significant unusual transactions.[7]

Introduction

Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* ("Practice Alert No. 3"), was issued in December 2008 to assist auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis.[8] Practice Alert No. 3 reminds auditors that the auditors' response to the risks of material misstatement due to fraud includes evaluating the business rationale for significant unusual transactions. In the staff's view, although the economic conditions have changed since December 2008, the risk factors, including the risks of significant unusual transactions, that existed in December 2008 continue to exist today and may affect the risk of material misstatement.

The existing standards of the PCAOB contain a variety of requirements related to significant, unusual, or complex transactions, or a combination thereof. The purpose of this staff audit practice alert is to complement Practice Alert No. 3 by compiling selected, relevant requirements from existing PCAOB auditing standards regarding significant unusual transactions into one document. While this alert summarizes certain areas with respect to significant unusual transactions, it is not intended to, and does not, serve as a substitute for the relevant standards of the PCAOB. Nor does this alert change the auditor's responsibilities regarding significant, unusual, or complex transactions. This alert reminds auditors of certain responsibilities with respect to significant unusual transactions and assists auditors in assessing and responding to the risks of material misstatement associated with these transactions during reviews of interim financial information and audits of financial statements, including integrated audits.

This alert groups the existing requirements for significant unusual transactions into the following categories: (1) identifying and assessing risks of material misstatement, (2) responding to risks of material misstatement, (3) consulting others, (4) evaluating financial statement presentation and disclosure,[9] (5) communicating with audit committees, and (6) reviewing interim financial information.

Identifying and Assessing Risks of Material Misstatement

The auditor's identification of significant unusual transactions is informed by the performance of audit procedures and the auditor's knowledge of the

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[6] Paragraph .07 of AU sec. 380, *Communication With Audit Committees*.

[7] Paragraphs 12 and 17 of Auditing Standard No. 7, *Engagement Quality Review*. AS No. 7 is effective for audits of financial statements and reviews of interim financial information for fiscal years beginning on or after December 15, 2009.

[8] Staff Audit Practice Alert No. 3 is available at http://pcaobus.org/Standards/QandA/12-05-2008_APA_3.pdf.

[9] The PCAOB has no authority to prescribe the form or content of an issuer's financial statements. Accordingly, while this staff audit practice alert describes authoritative accounting guidance, it does not establish or interpret that accounting guidance. See Staff Questions and Answers, References to Authoritative Accounting Guidance in PCAOB Standards, available at http://pcaobus.org/Standards/QandA/2009-09-02_FASB_Codification.pdf.

company's business and industry. The auditor should obtain knowledge of matters that relate to the nature of the company's business, its organization, and its operating characteristics.[10] Such matters include, for example, the type of business, types of products and services, and related parties.[11] The auditor also should consider matters affecting the industry in which the company operates, such as accounting practices common to the industry, competitive conditions, and financial trends and ratios.[12]

The auditor should consider whether the information obtained about the company and its environment indicates that one or more fraud risk factors are present, including significant unusual transactions.[13] The auditor also should consider identified fraud risk factors in identifying and assessing risks of material misstatement due to fraud.[14] In obtaining the information needed to identify risks of material misstatement due to fraud, the auditor, among other things, should inquire of others within the company about the existence or suspicion of fraud, including, for example, employees involved in initiating, recording, or processing significant unusual transactions.[15] The auditor also should perform analytical procedures when planning the audit with one objective being the identification of significant unusual transactions.[16] The auditor's assessment of the risks of material misstatement due to fraud, including those regarding significant unusual transactions, should be ongoing throughout the audit.[17]

The auditor should take into account the results of the fraud risk assessment when planning and performing an audit of internal control over financial reporting.[18] The auditor should evaluate whether the company's controls (including controls over significant unusual transactions, particularly those that result in late or unusual journal entries) sufficiently address the identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls.[19]

Responding to Risks of Material Misstatement

When the auditor has concluded that there is a significant risk of material misstatement of the financial statements, the auditor should consider this conclusion in determining the nature, timing, or extent of procedures; assigning staff; or requiring appropriate levels of supervision.[20] The auditor's response to the assessment of the risks of material misstatement of the financial statements due to fraud is influenced by the nature and significance of the risks identified as being present and the company's programs and controls that address these identified risks.[21]

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[10] Paragraph .07 of AU sec. 311, *Planning and Supervision*.

[11] Ibid.

[12] Ibid.

[13] AU sec. 316.32.

[14] Ibid.

[15] AU sec. 316.24-.25.

[16] AU sec. 316.28.

[17] AU sec. 316.68.

[18] Paragraph 14 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

[19] Ibid.

[20] AU secs. 312.17 and 316.50.

[21] AU sec. 316.47.

The auditor's response to the assessment of the risks of material misstatement due to fraud involves the application of professional skepticism in gathering and evaluating audit evidence.[22] Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud associated with significant unusual transactions.[23]

As part of the overall responses to the risks of material misstatement due to fraud, the auditor should consider management's selection and application of significant accounting principles, including those related to significant unusual transactions.[24] In this respect, the auditor may have a greater concern about whether the accounting principles selected and policies adopted are being applied in an inappropriate manner to create a material misstatement of the financial statements.[25] The auditor should consider whether their collective application indicates a bias that might create a material misstatement of the financial statements.[26] In examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, the auditor should consider that inappropriate entries or adjustments may be applied to accounts that contain significant unusual transactions.[27] The auditor also should evaluate whether analytical procedures that were performed in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement resulting from significant unusual transactions.[28]

In evaluating whether the business rationale (or the lack thereof) for significant unusual transactions suggests that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets, the auditor should consider:

- Whether the form of such transactions is overly complex;
- Whether management has discussed the nature of and accounting for such transactions with the audit committee or board of directors;
- Whether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction;
- Whether transactions that involve unconsolidated related parties, including special purpose entities, have been properly reviewed and approved by the audit committee or board of directors; and
- Whether the transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the company under audit.[29]

If the company has entered into a significant unusual transaction and the combined assessed level of inherent and control risk is high, in addition to

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[22] AU sec. 316.13. In addition, paragraphs .07-.09 of AU sec. 230, *Due Professional Care in the Performance of Work*, notes that due professional care requires the auditor to exercise professional skepticism.

[23] Ibid.

[24] AU sec. 316.50.

[25] Ibid.

[26] Ibid.

[27] AU secs. 316.58 and .61.

[28] AU sec. 316.69.

[29] AU secs. 316.66-67.

examining documentation held by the company, the auditor should consider confirming the terms and amounts of the transaction with the other parties.[30] The auditor also should obtain an understanding of the substance of the transaction to determine the appropriate information to include on the confirmation request.[31]

The auditor must identify all significant findings or issues (including significant unusual transactions) in an engagement completion document.[32] The auditor must document actions taken to address significant unusual transactions (including additional evidence obtained), and the basis for the conclusions reached.[33] In addition, a principal auditor that decides not to make reference to the audit of another auditor, among other things, must obtain, review, and retain an engagement completion document from that auditor.[34]

Engagement Quality Review

The engagement quality reviewer should review the engagement completion document and confirm with the engagement partner that there are no significant unresolved matters, including unresolved matters related to significant unusual transactions.[35] The engagement quality reviewer also should, among other things, evaluate whether (1) appropriate consultations have taken place on difficult or contentious matters, and review the documentation, including conclusions, of such consultations and (2) appropriate matters have been communicated, or identified for communication, to the audit committee, management, and other parties, such as regulatory bodies.[36]

Consulting Others

A firm's policies and procedures should provide reasonable assurance that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate (for example, when dealing with significant unusual transactions).[37] Individuals consulted should have appropriate levels of knowledge, competence, judgment, and authority.[38] The nature of the arrangements for consultation depends on a number of factors, including the size of the firm and the levels of knowledge, competence, and judgment possessed by the persons performing the work.[39] In addition, procedures performed by filing reviewers for U.S. Securities and Exchange Commission ("SEC") filings by SEC registrants audited by foreign associated firms of registered firms that were members of the American Institute of Certified Public Accountants' SEC Practice Section should generally include discussing with the engagement partner any significant auditing, accounting, financial reporting, and independence matters that come to the attention of the filing reviewer, including how such matters were addressed and resolved.[40]

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[30] Paragraph .08 of AU sec. 330, *The Confirmation Process*.

[31] AU sec. 330.25.

[32] Paragraphs 12 and 13 of Auditing Standard No. 3, *Audit Documentation*.

[33] Paragraph 12 of Auditing Standard No. 3.

[34] Paragraph .12 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

[35] Paragraph 10.e of Auditing Standard No. 7.

[36] Paragraphs 10.h and 10.i of Auditing Standard No. 7.

[37] QC sec. 20.19.

[38] Ibid.

[39] Ibid.

[40] PCAOB Rule 3400T, *Interim Quality Control Standards*.

Evaluating Financial Statement Presentation and Disclosure

The auditor's opinion that the financial statements are presented fairly in conformity with the applicable financial reporting framework should be based on whether:

a. The accounting principles selected and applied have general acceptance;[41]

b. The accounting principles are appropriate in the circumstances;

c. The financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation;

d. The information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed; and

e. The financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.[42]

The auditor's judgment concerning the "fairness" of the overall presentation of financial statements should be applied within the framework of generally accepted accounting principles.[43] Generally accepted accounting principles recognize the importance of reporting transactions and events in accordance with their substance.[44] The auditor should consider whether the substance of transactions or events, including significant unusual transactions, differs materially from their form.[45]

The presentation of financial statements in conformity with generally accepted accounting principles includes adequate disclosure of material matters.[46] An auditor considers whether a particular matter should be disclosed by management in light of the circumstances and facts of which he or she is aware at the time.[47] A basic tenet of the auditing standards of reporting states, "[i]nformative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."[48] If management omits from the financial statements, including the accompanying notes, information that is required by generally accepted accounting principles, the auditor should determine the effect on his or her audit report.[49] The auditor also may emphasize

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[41] The auditor should look to the requirements of the SEC for the company under audit with respect to accounting principles applicable to that company. See Rule 4-01 of Regulation S-X.

[42] Paragraph .04 of AU sec. 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles.

[43] AU sec. 411.03.

[44] AU sec. 411.06.

[45] Ibid.

[46] Paragraph .02 of AU sec. 431, *Adequacy of Disclosure in Financial Statements*.

[47] Ibid. When an auditor becomes aware of information that relates to financial statements previously reported on by the auditor, but which was not known to the auditor at the date of the report, and which is of such a nature and from such a source that the auditor would have investigated it had it come to the auditor's attention during the course of the audit, the auditor should take the actions described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

[48] Paragraph .02 of AU sec. 150, *Generally Accepted Auditing Standards*, and AU sec. 431.01.

[49] AU sec. 431.03.

a matter regarding the financial statements in a separate paragraph of the auditor's report.[50]

In addition, the auditor should read the other information accompanying the interim and annual financial statements contained in reports filed with the SEC.[51] For example, the Management's Discussion and Analysis of Financial Condition and Results of Operations section of annual reports and other filings might include discussions regarding significant unusual transactions.[52] The auditor should consider whether that information or the manner of its presentation is materially inconsistent with the financial statements. If the auditor concludes that there is a material inconsistency, or becomes aware of information that he or she believes is a material misstatement of fact, the auditor should determine if the financial statements, the audit report, or both require revision. If the auditor concludes that the financial statements or audit report do not require revision, the auditor should request the company to revise the other information.[53]

Communicating With Audit Committees

The auditor should determine that the company's audit committee is informed about the methods used to account for significant unusual transactions.[54] The auditor also should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting.[55] The discussion should be open and frank and generally should include such matters as the clarity and completeness of the company's financial statements, which include related disclosures.[56] In addition, the discussion should include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.[57] Items that may have such an impact include significant unusual transactions.[58]

Reviewing Interim Financial Information

The objective of a review of interim financial information is to provide the auditor with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles.[59] The objective of a review differs significantly from that of an audit of annual financial statements and consists principally of performing analytical procedures and making inquiries of persons responsible for financial and accounting matters.[60] Certain

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[50] Paragraph .19 of AU sec. 508, *Reports on Audited Financial Statements*.

[51] Paragraph 18(f) of AU sec. 722, *Interim Financial Information*, and paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

[52] For example, Item 303(a)(3)(i) of Regulation S-K instructs management to "[d]escribe any unusual or infrequent events or transactions or any significant economic changes that materially affected the amount of reported income from continuing operations and, in each case, indicate the extent to which income was so affected."

[53] AU secs. 550.04-05.

[54] AU sec. 380.07.

[55] AU sec. 380.11.

[56] Ibid

[57] Ibid.

[58] Ibid.

[59] AU sec. 722.07.

[60] Ibid.

auditing procedures may be performed concurrently with the review of interim financial information.[61] For example, there may be significant unusual transactions occurring during the interim period under review for which the auditing procedures needed for purposes of the audit of the annual financial statements could be performed, to the extent practicable, at the time of the interim review.[62]

During a review of interim financial information, the auditor should make inquiries of members of management who have responsibility for financial and accounting matters.[63] Specifically, the auditor should inquire about, among other things (a) significant unusual transactions that may have an effect on the interim financial information, and (b) significant unusual transactions occurring or recognized in the last several days of the interim period.[64] If the auditor becomes aware of information that leads him or her to believe that the interim financial information may not be in conformity with generally accepted accounting principles in all material respects, the auditor should make additional inquiries or perform other procedures that he or she considers appropriate to provide a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information.[65]

When conducting a review of interim financial information, the auditor also should determine whether significant unusual transactions have been identified.[66] If such transactions have been identified, the auditor should communicate them to the audit committee, or be satisfied, through discussion with the audit committee, that such matters have been communicated to them by management.[67]

Standards-Setting Activities

The PCAOB has a project on its standards-setting agenda to address the auditing standards regarding related parties. In connection with that project, the PCAOB is evaluating its auditing standards regarding the consideration of significant unusual transactions. In addition, the PCAOB also has on its standards-setting agenda projects to address other standards referenced in this practice alert. Updates on these activities are available on the PCAOB's website. Relevant links are provided below:

- Release No. 2009-007, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, available at: http://pcaobus.org/Rules/Rulemaking/Docket%20026/2009-12-16_Release_No_2009-007.pdf
- Release No. 2010-001, *Proposed Auditing Standard Related to Communications With Audit Committees and Related Amendments to Certain PCAOB Auditing Standards*, available at: http://pcaobus.org/Rules/Rulemaking/Docket030/Release_No_2010-001.pdf

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[61] AU sec. 722.23.

[62] Ibid.

[63] AU sec. 722.18c.

[64] Ibid. AU sec. 722.55 contains examples of situations about which the auditor ordinarily inquires of management during a review of interim financial information.

[65] AU sec. 722.22.

[66] AU secs. 722.33-.34.

[67] Ibid.

- Release No. 2009-002, *Concept Release on Possible Revisions to the PCAOB's Standard on Audit Confirmations*, available at: http://pcaobus.org/Rules/Rulemaking/Pages/Docket028.aspx.
- Standing Advisory Group Meeting briefing paper, Responsibilities of the Principal Auditor, available at: http://pcaobus.org/News/Events/Documents/04072010_SAGMeeting/Principal_Auditor_Briefing_Paper.pdf.

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.06 Staff Audit Practice Alert No. 6

Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants From Outside the Firm

July 12, 2010

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Introduction

The PCAOB staff has observed that a number of registered public accounting firms located in the United States ("U.S.") have been issuing audit reports on financial statements filed by issuers that have substantially all of their operations outside of the U.S. Although there is nothing inherently inappropriate about this, observations from the Board's inspection process suggest that some firms may not be conducting those audits in accordance with PCAOB standards. Specifically, some firms may be issuing audit reports based on the work of another firm, or by using the work of assistants engaged from outside of the firm, without complying with relevant PCAOB standards.

The circumstances in which such conduct occurs often involve issuers that are incorporated in the U.S. (and that file their annual reports with the Securities and Exchange Commission ("SEC") on Form 10-K), even though substantially all of their operations are in another country. In this context, a number of issuers have come to be incorporated in the U.S., and to have securities trading in the U.S., following a transaction in which an operating company in another country merges with a U.S. shell company that had previously registered its securities under the Securities Exchange Act of 1934.

The number of issuers that file financial statements audited by U.S. auditors, while having substantially all of their operations in another country, has increased in recent years. The demand for those audit services is met by U.S registered public accounting firms of various sizes, including small firms.[1] The

[1] For example, in a 27-month period ending March 31, 2010, at least 40 U.S. registered public accounting firms with fewer than five partners and fewer than ten professional staff issued audit reports on financial statements filed with the SEC by companies whose operations were

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Board's inspection staff has observed some situations in which it appeared that U.S. registered public accounting firms that provided those auditing services did so by having all or most of the audit performed by another firm or by assistants engaged from outside the firm (including firms and assistants located in another country) without complying with PCAOB standards applicable to using the work and reports of another auditor and supervising assistants.[2] Prompted by those observations, this Alert is intended as a reminder to registered firms concerning a firm's obligations when using the work of other firms or using assistants engaged from outside the firm.

Using the Work of Other Auditors

AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, establishes requirements that apply when an auditor of an issuer's financial statements "use[s] 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 [that issuer's] financial statements."[3]

The Board's inspection staff has identified indications that some U.S. firms auditing issuers with substantially all of their operations in another country are not properly applying AU sec. 543. For example, in one situation, a U.S. firm engaged to audit such an issuer retained an accounting firm in the China region to perform audit procedures. In the year preceding the audit, the U.S. firm's managing partner and engagement partner traveled to the China region to meet with the issuer's board of directors, the issuer's management, and the other firm in order to gain an understanding of the issuer's business and processes and review with the other firm its audit process. The U.S. firm's personnel did not travel to the China region during the audit, and the audit procedures performed by the other firm constituted substantially all of the audit procedures on the issuer's financial statements. The firm in the China region did not issue a report, and substantially all of the audit documentation was maintained by the firm in the China region. Based on its view that AU sec. 543 applied and permitted it to do so, the U.S. firm issued an audit report stating that it had audited the financial statements and expressing an unqualified opinion on the financial statements. The inspection staff, however, concluded that it was inappropriate for the firm to serve as principal auditor and use the work of the other auditor pursuant to AU sec. 543.

(footnote continued)

substantially all in the China region. (As used in this Staff Audit Practice Alert, the term "China region" includes the People's Republic of China, Hong Kong Special Administrative Region, and Taiwan.) This trend has also attracted attention, and was a subject of discussion at a recent meeting of the Board's Standing Advisory Group (available beginning at minute 43:15 of the archived Webcast at http://pcaobus.org/News/Webcasts/Documents/2010/pcaob-040710-p2.mp3). This trend is not necessarily limited to the China region, and the discussion in this Staff Audit Practice Alert of issues associated with the U.S. registered public accounting firms' audits of companies whose operations were substantially all in the China region also is relevant to audits of companies located in other jurisdictions.

[2] Where appropriate, the Board follows up on indications of such misconduct with enforcement investigations, disciplinary proceedings, and sanctions. By law, these Board processes are nonpublic unless and until they result in a final disciplinary sanction taking effect. In one completed matter, the Board imposed sanctions in a case in which a U.S. firm used a significant amount of audit work performed by a Hong Kong firm without adequately coordinating its work with that of the Hong Kong firm. See *In the Matter of Clancy and Co., P.L.L.C., Jennifer C. Nipp, CPA, and Judith J. Clancy, CPA*, PCAOB Release No. 105-2009-001 (March 31, 2009). Referrals from the Board's inspection program to the Board's enforcement program relating to situations in which firms are using work of other firms or using assistants from outside the firm in connection with audits of foreign-based issuers have been on the rise.

[3] AU sec. 543.01.

Identifying Circumstances in Which AU sec. 543 Applies

AU sec. 543 applies only to circumstances in which a firm would use the "work and reports of other independent auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments" of an issuer.[4] AU sec. 543 does not provide a way for an auditor to take responsibility for the work of another auditor that has essentially audited an issuer's financial statements in their entirety, even if the firm complies with the other requirements in AU sec. 543. AU sec. 543 does not apply to the use of another auditor's work if that work is anything other than an audit of the financial statements of one or more subsidiaries, divisions, branches, components, or investments of the issuer.

Determining Whether to Serve as Principal Auditor

Even in circumstances where a firm has access to the work and reports of another auditor that has audited the financial statements of a subsidiary, division, branch, component, or investment, the firm cannot serve as principal auditor (and, accordingly, may not sign the audit report on the issuer's financial statements) unless the firm's own participation in the audit is sufficient.[5] In determining whether its participation is sufficient to serve as principal auditor, the firm "should consider, among other things, the materiality of the portion of the financial statements [the firm] audited in comparison with the portion audited by other auditors, the extent of [the auditor's] knowledge of the overall financial statements, and the importance of the components [the firm] audited in relation to the enterprise as a whole."[6] If an issuer has no significant operations other than those in another country, a registered public accounting firm that plays no significant part in the audit of the foreign operations is highly unlikely to have sufficient participation in the audit to serve as the issuer's principal auditor. A lack of sufficient participation cannot be overcome by using the work of the other auditor, even if the firm assumes responsibility for that work.

Responsibilities of the Principal Auditor

In circumstances in which AU sec. 543 applies and in which the firm's own participation is sufficient to serve as principal auditor, the principal auditor must comply with the other requirements in AU sec. 543 relative to the firm's use of the work and reports of the other auditor,[7] including:

- *Determining the Method of Reporting*—The principal auditor must decide, taking certain factors into account, whether to express an opinion on the financial statements taken as a whole without making reference to the audit of the other auditor (thereby assuming responsibility for the work of the other auditor) or to make reference to the audit of the other auditor.[8]

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[4] Ibid.

[5] See AU sec. 543.02.

[6] AU sec. 543.02. In an integrated audit, the auditor who serves as the principal auditor of the financial statements should also be the principal auditor of internal control over financial reporting ("ICFR") and so must participate sufficiently in the audit of ICFR to provide a basis for serving as the principal auditor of ICFR. See Paragraph C8 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.*

[7] AU sec. 543.03-.17.

[8] See AU sec. 543.03-.06.

- *Procedures Applicable to Both Methods of Reporting*—The principal auditor "should make inquiries concerning the professional reputation and independence of the other auditor [and] adopt appropriate 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."[9]
- *Procedures Applicable When Assuming Responsibility* – If the principal auditor assumes responsibility for the work of the other auditor, the principal auditor "must obtain, and review and retain ... prior to the report release date", certain specific information from the other auditor, and should also consider "[visiting] the other auditor and [discussing] the audit procedures followed and results thereof; [reviewing] the audit programs of the other auditor [and, if appropriate, issuing] instructions to the other auditor as to the scope of the audit work; [and/or reviewing] additional audit documentation of the other auditor relating to significant findings or issues in the engagement completion document."[10]

If the principal auditor assumes responsibility for the work of other auditors, the principal auditor should determine whether the results of the principal auditor's own work, combined with the results of the work of other auditors, provide sufficient competent evidential matter to afford a reasonable basis for an audit opinion on the issuer's financial statements.[11] In developing an opinion, the principal auditor "should consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements."[12]

The principal auditor must exercise due professional care in the performance of the audit.[13] When the principal auditor assumes responsibility for the other auditor's work, the principal auditor's review of the audit documentation obtained from the other auditor[14] and performance of other required procedures may identify issues requiring additional consideration by the principal auditor, such as the following issues observed in some audits by the Board's inspection staff:

- The other auditor did not comply with instructions issued by the principal auditor.
- The other auditor identified an accounting or auditing issue that the other auditor did not resolve.
- The other auditor performed an audit in accordance with auditing standards other than the standards of the PCAOB.

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[9] AU sec. 543.10. In connection with this point, both the principal auditor and auditors whose work and reports the principal auditor uses should be cognizant of PCAOB registration requirements. Under section 102(a) of the Sarbanes-Oxley Act of 2002 and PCAOB Rule 2100, *Registration Requirements for Public Accounting Firms*, an auditor whose work and report the principal auditor uses must be registered with the PCAOB if that auditor's work constitutes a substantial role in the preparation or furnishing of? the audit report on the issuer's financial statements, as defined in PCAOB Rule 1001(p)(ii), *Definitions of Terms Employed in Rules / Play a Substantial Role in the Preparation or Furnishing of an Audit Report*.

[10] AU sec. 543.12.

[11] See paragraph .02 of AU sec. 150, *Generally Accepted Auditing Standards*, and paragraph .08 of AU sec. 230, *Due Professional Care in the Performance of Work*.

[12] Paragraph .25 of AU sec. 326, *Evidential Matter.*

[13] See AU sec. 230.01.

[14] AU sec. 543.12 describes certain specific information that the principal auditor must obtain from the other auditor.

- The other auditor reported on the financial statements of a component that prepares its financial statements in accordance with a financial reporting framework[15] other than the framework used to prepare the financial statements of the issuer as a whole.

To the extent the principal auditor has substantial doubt about any financial statement assertion of material significance, the principal auditor "must refrain from forming an opinion until [the principal auditor] has obtained sufficient competent evidential matter to remove such substantial doubt, or ... must express a qualified opinion or a disclaimer of opinion."[16] For example, if the principal auditor determines that the work of the other auditor does not provide the necessary audit evidence, the principal auditor should take appropriate actions to obtain sufficient competent evidence, including "[participating] in discussions regarding the accounts with management personnel of the component whose financial statements are being audited by other auditors and/or [making] supplemental tests of such accounts."[17]

Language Considerations

Appropriately satisfying the requirements described above necessarily entails overcoming any language barriers. If the appropriate supervisory personnel of the principal auditor are not sufficiently fluent in the language in which the audit documentation of the other auditor is prepared, the principal auditor must take the necessary actions to enable the principal auditor to fulfill its responsibilities in accordance with PCAOB standards. The principal auditor can neither omit the procedures described in AU sec. 543 because of language differences, nor satisfy those requirements by reference to documents that the principal auditor does not understand.

Engaging Assistants from Outside the Firm

The previous section describes certain requirements in PCAOB standards that apply when a principal auditor uses the work and reports of other auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements presented. In other situations, the auditor might engage assistants from outside the firm in performing the audit. The auditor's responsibilities related to the work of assistants engaged from outside the firm are governed by the same standards as the auditor's responsibilities related to the work of assistants who are associated with the auditor's firm as a partner, shareholder, or employee.

The Board's inspection staff has identified situations in which U.S. firms auditing companies with substantially all of their operations in another country appeared not to have appropriately executed their responsibilities with respect to the work of assistants engaged from outside of the firm. For example, in one situation, a U.S. firm retained the services of a consulting firm that had personnel who could read, write, and speak the language of the area, in the China region, in which the issuer's operations were located. Those consultants planned the audit, communicated with the issuer's management, and traveled to the China region to complete a substantial portion of the audit. None of

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[15] U.S. generally accepted accounting principles and International Financial Reporting Standards are examples of a financial reporting framework. Auditors should look to the requirements of the SEC for the issuer under audit with respect to the accounting framework applicable to the issuer.

[16] AU sec. 326.25.

[17] AU sec. 543.13.

the U.S. firm's partners or employees traveled to the China region or planned, performed, supervised, or meaningfully reviewed the audit work. Procedures performed by the U.S. firm's engagement partner consisted primarily of reviewing certain work papers prepared by the consultants as well as issuer-prepared draft financial statements and lead schedules that had been translated into English. The inspection staff concluded that the level of the firm's involvement in the audit work performed by the consultants was not sufficient for the firm to assert that an audit had been performed by the firm and that the audit provided a reasonable basis for the firm to have an opinion on the financial statements.

As described further in this Alert, some key considerations in determining the appropriate level of the firm's involvement in audit work performed by assistants engaged from outside the firm (including planning, performing, and supervising the audit work) include, but are not limited to, the following:

- Whether the auditor would be able to obtain information about the knowledge, skill, and ability of the assistants engaged from outside the firm (including their knowledge of PCAOB standards and the relevant financial reporting requirements), and to evaluate the independence of the assistants engaged from outside the firm.
- Whether the auditor would be able to properly plan and supervise the work of the assistants engaged from outside the firm and whether the auditing procedures performed by such assistants, in combination with the work performed by individuals from within the firm, would provide sufficient competent evidential matter to afford a reasonable basis for an audit opinion.
- Whether the assistants engaged from outside the firm are located in the same country or speak the same language as the auditor or the auditor's client.
- Whether the auditor would be able to comply with the documentation requirements, including the preparation, assembly, and retention of documentation, with respect to the work performed by the assistants engaged from outside the firm.

Knowledge, Skill, Ability, and Independence

As is the case when a registered public accounting firm deploys its own partners, shareholders, or employees on an audit, when a registered public accounting firm engages assistants from outside of the firm, the firm's engagement partner "is responsible for the assignment of tasks to, and supervision of, [those] assistants."[18] Those assistants, like all assistants, should be "assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability,"[19] which necessarily requires the person who assigns and supervises the assistants to have an understanding of the level of knowledge, skill, and ability possessed by those assistants. The knowledge, skill, and ability of personnel assigned significant engagement responsibilities also should be commensurate

[18] AU sec. 230.06.

[19] Ibid. A registered public accounting firm has a responsibility to ensure that all individuals who perform audit procedures for which the firm is responsible, including assistants engaged from outside the firm, comply with the professional standards applicable to the firm's auditing practice (see QC sec. 20.03) and that work is assigned to individuals who have the degree of technical training and proficiency required in the circumstances (see QC sec. 20.13).

with the auditor's assessment of the level of risk for the engagement, including the risk of material misstatement due to fraud.[20] Ordinarily, higher risk requires the assignment of more experienced personnel or additional persons with specialized skills and knowledge, e.g., information technology or forensic specialists.[21]

As for independence, the registered public accounting firm must approach independence considerations concerning the assistants engaged from outside the firm as if they were employees of the firm.[22]

Planning and Supervision

The registered public accounting firm is responsible for planning the audit, and for ensuring that the work of assistants is supervised and reviewed in accordance with PCAOB standards.

As the "auditor with final responsibility for the audit", as that term is used in paragraph .02 of AU sec. 311, *Planning and Supervision*, the registered public accounting firm's engagement partner is responsible for audit planning, which involves developing an overall strategy for the expected conduct and scope of the audit.[23] Procedures that an auditor may consider in planning the audit usually involve review of records relating to the company and discussions with assistants, including assistants engaged from outside the firm, and management of the company, the board of directors, or its audit committee.[24] "In planning the audit, the auditor should consider the nature, extent, and timing of work to be performed and should prepare a written audit program (or set of written audit programs).[25]

"The auditor should obtain a level of knowledge of the [issuer's] business that will enable [the auditor] to plan and perform [the] audit in accordance with [PCAOB standards]."[26] "Knowledge of an [issuer's] business is ordinarily obtained through experience with the [issuer] or its industry and inquiry of personnel of the [issuer]."[27] Prior to, or in conjunction with, gathering information about the issuer's business, the engagement partner and key members of the audit team, including any engaged from outside the firm, should discuss the potential for material misstatement due to fraud.[28] The discussion should include, among other things, "an exchange of ideas or "brainstorming" ... about how and where [the auditor] believe[s] the [issuer'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 [issuer] could be misappropriated."[29]

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[20] See paragraph .17 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, and paragraph .50 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

[21] Ibid.

[22] PCAOB standards require that policies and procedures be established to provide the firm with reasonable assurance that individuals who perform the audit maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities. (See QC sec. 20.09.)

[23] See AU sec. 311.03, and paragraph 9 of Auditing Standard No. 5.

[24] See AU sec. 311.04 (including examples of such procedures).

[25] AU sec. 311.05.

[26] AU sec. 311.06.

[27] AU sec. 311.08.

[28] See AU sec. 316.14 and AU sec. 316.17.

[29] AU sec. 316.14.

Appropriate supervision and review necessarily entails overcoming any language barriers. The engagement partner is responsible for the supervision of assistants, including any engaged from outside the firm.[30] "Elements of supervision include instructing assistants, keeping informed of significant problems encountered, reviewing the work performed, and dealing with differences of opinion ... The extent of supervision appropriate in a given instance depends on many factors, including the complexity of the subject matter and the qualifications of persons performing the work."[31] "Ordinarily, higher risk requires ... more extensive supervision by the [engagement partner] during both the planning and the conduct of the engagement."[32] Also, "the extent of supervision should reflect the risks of material misstatement due to fraud."[33] "The work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report."[34]

Audit Documentation

The registered public accounting firm is responsible for ensuring that all audit documentation – including the documentation of the work of the assistants – necessary to meet the PCAOB's documentation requirements is prepared and retained.[35] Auditing Standard No. 3, *Audit Documentation*, "establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to the standards of the PCAOB."[36] Among other things, Auditing Standard No. 3 requires that the auditor "identify all significant findings or issues in an engagement completion document."[37] These requirements are applicable in situations in which the auditor engages, as assistants, individuals from outside the firm.

Engagement Quality Review

"[T]he engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the [audit] report"[38] including "[reviewing] the engagement completion document and [confirming] with the engagement partner that there are no significant unresolved matters."[39] "[T]he firm may grant permission to the client to use the [audit] report only after the engagement quality reviewer provides concurring approval of issuance."[40]

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[30] See AU sec. 230.06.

[31] AU sec. 311.11.

[32] AU sec. 312.17.

[33] AU sec. 316.50.

[34] AU sec. 311.13.

[35] See paragraph 18 of Auditing Standard No. 3, *Audit Documentation*.

[36] Paragraph 1 of Auditing Standard No. 3.

[37] Paragraph 13 of Auditing Standard No. 3.

[38] Paragraph 9 of Auditing Standard No. 7, *Engagement Quality Review*.

[39] Paragraph 10.e of Auditing Standard No. 7, *Engagement Quality Review*.

[40] Paragraph 13 of Auditing Standard No. 7.

Standard-setting Activities

The Board has a project on its standard-setting agenda regarding the responsibilities of the principal auditor. The Board's Standing Advisory Group discussed this topic at its April 7-8, 2010 meeting.[41]

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[41] See briefing paper available at http://pcaobus.org/News/Events/Documents/04072010_SAGMeeting/Principal_Auditor_Briefing_Paper.pdf.

.07 Staff Audit Practice Alert No. 7

Auditor Considerations of Litigation and Other Contingencies Arising From Mortgage and Other Loan Activities

December 20, 2010

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Background

In the fall of 2010, allegations surfaced that banks may have misrepresented the quality of mortgages sold and that those banks could be required to repurchase the affected mortgages.[1] Additional allegations have been made that companies servicing $6.4 trillion in American mortgages may have bypassed legally required steps to foreclose on homes.[2] Some of these practices could result in loss contingencies for certain financial institutions that may require recognition of liabilities or disclosure in financial statements.[3]

The situation remains fluid, with estimates of potential costs associated with foreclosure irregularities and mortgage repurchases ranging from "manageable" to an exposure for the industry of up to $52 billion.[4] Some experts have acknowledged scenarios in which the title and legal documentation problems related to foreclosures could lead to significant effects on banks' balance sheets.[5]

Numerous federal and state agencies are coordinating their efforts to review practices that may not comply with state foreclosure laws or applicable federal

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[1] Congressional Oversight Panel, *November Oversight Report* (November 16, 2010), available at: http://cop.senate.gov/reports/library/report-111610-cop.cfm.

[2] Ibid.

[3] Loss contingencies may include, among others, accruals for liabilities relating to representations and warranties made at the time loans were sold or for litigation costs.

[4] *November Oversight Report*, p. 52.

[5] Ibid.

laws[6] and to provide for better disclosures and improve transparency in the securitization market.

As part of the efforts to provide for better disclosures, in October 2010, the United States Securities and Exchange Commission's ("SEC") Division of Corporation Finance sent letters to certain public companies as a reminder of their disclosure obligations with respect to their forthcoming quarterly reports on Form 10-Q and subsequent filings. The letters highlighted continued concerns about potential risks and costs associated with mortgage and foreclosure-related activities or exposures. The sample letter posted to the SEC Web site stated that companies should consider certain items for disclosure, including, without limitation, "the impact of various representations and warranties regarding mortgages made to purchasers of the mortgages (or to purchasers of mortgage-backed securities) including to the government-sponsored entities (GSEs), private-label mortgage-backed security (MBS) investors, financial guarantors and other whole loan purchasers."[7]

The letters further reminded companies of the requirements for disclosures in Management's Discussion and Analysis for Forms 10-Q and 10-K under Item 303 of Regulation S-K and for accruing and disclosing loss contingencies in the financial statements under the Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") Topic 450, Contingencies, Subtopic 450-20. Companies were reminded that, as appropriate, they should consider the need to accrue loss contingencies and to provide clear and transparent disclosure regarding obligations relating to the various representations and warranties that were made in connection with securitization activities and whole loan sales, and to discuss any implications of any foreclosure reviews, including potential delays in completing foreclosures. If applicable, these disclosures would address the company's role as an originator, securitizer, servicer, and investor.

The letters cautioned companies to consider a number of matters when preparing their quarterly and subsequent filings (e.g., litigation risks and uncertainties related to any known or alleged defects in the securitization process, including any potential defects in mortgage documentation or in the assignment of the mortgages). The letter also cautioned that some of these issues are not limited to financial institutions.

This practice alert advises auditors that the potential risks and costs associated with mortgage and foreclosure-related activities or exposures, such as those discussed in the SEC staff letters, could have implications for audits of financial statements or of internal control over financial reporting. These implications might include accounting for litigation or other loss contingencies and the related disclosures. Auditors should consider the effect of these matters during their reviews of interim financial information, year-end audits, and attestation engagements on assessments of compliance with servicing criteria.

Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* ("Practice Alert No. 3"), was issued in December 2008 to assist auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis.[8] Among other things,

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[6] White House, Office of the Press Secretary, *Fact Sheet: Federal Government Efforts to Support Accountability, Stability and Clarity in the Housing Market*, dated October 20, 2010.

[7] Neither companies nor public accounting firms should rely on the summary of the SEC staff letter in this practice alert, but should review the letter in its entirety. The SEC staff sample letter is available at: http://www.sec.gov/divisions/corpfin/guidance/cfoforeclosure1010.htm.

[8] Staff Audit Practice Alert No. 3 is available at: http://pcaobus.org/Standards/QandA/12052008_APA_3.pdf.

Practice Alert No. 3 provides auditors with information on selected financial reporting areas, including contingencies and guarantees that may be affected by the economic environment, and reminds auditors of the requirements regarding accounting estimates.

Audit risks that existed in December 2008 with respect to contingencies and guarantees, as well as potential other issues, continue to exist today. These audit risks potentially affect the risk of material misstatement, as evidenced by recent concerns regarding problematic foreclosures and asserted claims or potential litigation relating to representations and warranties made in connection with securitizations or whole loan sales. Auditors may need to consider the possible effects that these issues might have on the nature, timing, and extent of planned audit procedures.[9]

Matters for the auditor's consideration

In light of continued concerns about potential risks and costs associated with mortgage and foreclosure-related activities or exposures, this practice alert reminds auditors of their responsibilities with respect to auditing loss contingencies, disclosures, and other related topics.

Auditing Litigation, Claims, and Assessments

Companies that may be affected by mortgage and foreclosure-related activities or exposures may need to accrue for or provide disclosures relating to legal contingencies.[10]

AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, establishes requirements with respect to litigation, claims, and assessments.[11] This standard states that in order to identify litigation, claims, and assessments, and to become satisfied with the accounting and reporting of such matters, the auditor should gather sufficient and appropriate audit evidence relevant to the following factors:

- The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments;
- The period in which the underlying cause for legal action occurred;[12]
- The degree of probability of an unfavorable outcome; and
- The amount or range of potential loss.[13]

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[9] Paragraph .33 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*.

[10] FASB ASC Subtopic 45020 requires companies to establish accruals for litigation and other contingencies when it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. In an audit of a foreign private issuer ("FPI") whose financial statements are prepared in conformity with International Financial Reporting Standards ("IFRS"), the auditor should refer to applicable accounting and disclosure requirements of the International Accounting Standards Board ("IASB"). PCAOB standards apply regardless of the applicable financial reporting framework.

[11] AU sec. 337.01.

[12] According to paragraphs .01 and .04 of AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, when an auditor becomes aware of information that relates to financial statements previously reported on by the auditor, but which was not known to the auditor at the date of the report, and which is of such a nature and from such a source that the auditor would have investigated it had it come to the auditor's attention during the course of the audit, the auditor should take the actions described in AU sec. 561.

[13] AU sec. 337.04.

AU sec. 337 discusses the procedures the auditor should perform regarding litigation, claims, and assessments[14] and also states that although certain audit procedures may be undertaken for other purposes, they might also disclose litigation, claims, and assessments (e.g., reading minutes of meetings of stockholders, directors, and appropriate committees held during and subsequent to the period being audited; reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies; or inspecting similar documents).[15] Further, the auditor should obtain a letter from the client's lawyer to assist the auditor in corroborating the information furnished by management concerning litigation, claims, and assessments.[16]

Auditing Accounting Estimates

Companies involved in mortgage and foreclosure-related activities may need to estimate and accrue amounts for other potential loss contingencies including those related to various representations and warranties. AU sec. 342, *Auditing Accounting Estimates*, establishes requirements regarding obtaining and evaluating sufficient appropriate audit evidence for accounting estimates. In auditing accounting estimates, the auditor normally should consider the company's historical experience in making past estimates as well as the auditor's experience in auditing companies in the same industry.[17] However, changes in facts, circumstances, or a company's procedures may cause factors different from those considered in the past to become significant to the accounting estimate.[18] For example, a company's historical experience relating to repurchasing loans sold into securitization structures may not be indicative of future trends in that area.

According to AU sec. 342, when planning and performing procedures to evaluate the reasonableness of the company's accounting estimates, the auditor should consider, with an attitude of professional skepticism, the subjective and objective factors included in the estimate.[19] When evaluating accounting estimates relating to mortgage loan repurchase losses, such factors may include, among others, estimated levels of defects based on the company's review or experience, default expectations, investor repurchase demand, or appeal success rates.

Evaluating Financial Statement Presentation and Disclosure

Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include the related notes).[20] When such information is set forth elsewhere in a report to shareholders "it should be referred to in the financial statements."[21] If management omits from the financial statements, including the accompanying notes, information that is required by generally accepted accounting principles, the auditor should express a qualified or adverse opinion and should provide the information in the audit report, if practicable.[22]

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[14] AU sec. 337.05.

[15] AU sec. 337.07.

[16] AU sec. 337.08.

[17] AU sec. 342.09.

[18] Ibid.

[19] AU sec. 342.04.

[20] Paragraph .41 of AU sec. 508, *Reports on Audited Financial Statements*.

[21] Ibid.

[22] Paragraph .03 of AU sec. 431, *Adequacy of Disclosure in Financial Statements*.

In addition, the auditor should read the other information accompanying the interim and annual financial statements contained in reports filed with the SEC,[23] including the Management's Discussion and Analysis of Financial Condition and Results of Operations sections of annual reports and other filings.[24] The auditor should consider whether that information or the manner of its presentation is materially inconsistent with the financial statements. If the auditor concludes that there is a material inconsistency or becomes aware of information that he or she believes is a material misstatement of fact, the auditor should determine if the financial statements, the audit report, or both, require revision. If the auditor concludes that the financial statements or audit report do not require revision, the auditor should request the company to revise the other information.[25]

FASB ASC Topic 450, Contingencies, Subtopic 450-20 requires that when a loss is not both probable and estimable, an accrual is not recorded, but disclosure of the contingency is required to be made when there is at least a reasonable possibility that a loss or an additional loss has been incurred.[26] Companies involved in mortgage and foreclosure-related activities or exposures may need to establish new disclosures or enhance existing disclosures regarding litigation and other contingencies or estimates. For example, companies that sold or securitized loans but may not have complied with representations and warranties may be at risk of being forced to repurchase such loans. These companies may need to disclose or enhance their existing disclosures regarding the nature, timing, and uncertainty of their potential exposures as additional claims arise and are resolved.

Communication with Audit Committees

To the extent potential risks and costs associated with mortgage and foreclosure-related activities or exposures are identified, auditors are reminded of their responsibility to communicate with the audit committee. AU sec. 380, *Communication With Audit Committees*, includes requirements regarding communications relating to management judgments and accounting estimates.[27] Other communication with the audit committee includes such matters as the clarity and completeness of the company's financial statements, which include related disclosures[28] and a discussion of items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.[29] For example, in appropriate circumstances, this discussion would include the auditor's view on disclosures relating to representations and warranties that were made in connection with securitization activities.

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[23] Paragraph .18(f) of AU sec. 722, *Interim Financial Information*, and paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

[24] For example, Item 303(a)(1) of Regulation S-K instructs management to "[i]dentify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way."

[25] AU secs. 550.04–05.

[26] In an audit of a FPI whose financial statements are prepared in conformity with IFRS, the auditor should refer to applicable accounting and disclosure requirements of the IASB. PCAOB standards apply regardless of the applicable financial reporting framework.

[27] AU sec. 380.08.

[28] AU sec. 380.11.

[29] Ibid.

Reviewing Interim Financial Information

The objective of a review of interim financial information is to provide the auditor with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles.[30] AU sec. 722, *Interim Financial Information*, requires the auditor to make inquiries regarding unusual or complex situations that may have an effect on the interim information.[31] These situations may include changes in estimated loss contingencies as well as trends and developments affecting accounting estimates.[32]

If information obtained from performing review procedures leads the auditor to believe that the interim financial information may not be in conformity with generally accepted accounting principles in all material respects, the auditor should make additional inquiries or perform other procedures considered appropriate to provide a basis for communicating whether any material modifications should be made to the interim financial information.[33] AU sec. 722 provides additional requirements in cases where the auditor believes that a material modification should be made to the interim financial information.[34]

Ongoing Audit Considerations

As additional information is determined in future periods regarding the potential risks and costs associated with mortgage and foreclosure-related activities or exposures, auditors planning or performing an audit should acquire a sufficient understanding to assess how the additional information affects the nature and potential magnitude of the associated risks. Auditors 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.[35] Accordingly, auditors may need to consider, e.g., how documentation issues in the loan origination process at a bank affect the auditors' initial risk assessment, overall audit strategy and the audit plan.

Risks of material misstatement can arise from a variety of sources, including external factors, including 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 which can affect the judgments involved in determining accounting estimates or create pressures to manipulate the financial statements to achieve certain financial targets.[36]

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[30] AU sec. 722.07.

[31] AU sec. 722.18c.

[32] AU sec. 722.55B1.

[33] AU sec. 722.22.

[34] AU sec. 722.29–722.31.

[35] Paragraph 15 of Auditing Standard No. 9, *Audit Planning*. On August 5, the Board adopted Auditing Standards No. 8 through No. 15 related to the auditor's assessment of and response to risk ("the Risk Assessment Standards"), which, if approved by the SEC, would become effective for audits of fiscal periods beginning on or after December 15, 2010. For audits of fiscal periods before the Risk Assessment Standards are effective, auditors should refer to the relevant requirements of AU sec. 311, *Planning and Supervision*, AU sec. 312, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

[36] Paragraph 5 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

In an integrated audit, many factors can affect the risk associated with a control including the design of the control,[37] nature of the control and the frequency with which it operates as well as 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.[38] Accordingly, an increase in the volume of foreclosures or loan repurchases could affect the risks associated with related controls.

Attestation Reports on Assessments of Compliance With Servicing Criteria

Section 1122 of the SEC's Regulation AB requires an attestation report by a registered public accounting firm on a servicer's assessment of compliance with servicing criteria.[39] These criteria include, among other things, maintaining collateral or security on pool assets as required by the transaction agreements or related pool asset documents; and initiating, conducting, and concluding loss mitigation or recovery actions in accordance with the timeframes or other requirements established by the transaction agreements.[40]

In adopting Regulation AB, the SEC provided that AT sec. 601, *Compliance Attestation*, applies to the preparation of these attest reports[41] and generally requires that, in assessing whether the servicer has complied with the criteria, an auditor should consider risk factors similar to those an auditor would consider when planning an audit of financial statements,[42] as well as factors relevant[43] to the compliance engagement.[44] For example, in assessing risk, the auditor considers whether the servicer or its parent has identified noncompliance as part of an internal investigation, internal audit, or other compliance review.

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[37] Paragraph .42 of Auditing Standard No. 5.

[38] Paragraph .47, Auditing Standard No. 5.

[39] Item 1122, *Compliance with applicable servicing criteria*, under Regulation AB.

[40] Ibid.

[41] See SEC Release No. 338518, *Asset-Backed Securities* (December 22, 2004), which states in part: "On April 25, 2003, the Commission approved the PCAOB's adoption of the auditing and attestation standards in existence as of April 16, 2003 as interim auditing and attestation standards. The Attestation Standard for Compliance Attestation (AT sec. 601) in those interim auditing and attestation standards should be used in performing this examination engagement."

[42] AT sec. 601.33.

[43] Ibid.

[44] Rules 13a18(c) and 15d18(c) under the Exchange Act require that the attestation report on the assessment of compliance with servicing criteria for assetbacked securities be made in accordance with standards for attestation engagements issued or adopted by the PCAOB.

.08 Staff Audit Practice Alert No. 8
Audit Risks in Certain Emerging Markets

October 3, 2011

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the standards and rules of the PCAOB and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts do not establish rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Executive Summary

Emerging markets play an increasingly important role in the global economy given their high economic growth outlook and significant market size.[1] Recent disclosures of possible improprieties in financial reporting by companies based in certain large emerging markets in Asia and observations from the Board's oversight activities highlight the need for heightened awareness of risks when performing audits of companies with operations in emerging markets.

This practice alert focuses on risks of misstatement due to fraud ("fraud risks") that auditors might encounter in audits of companies with operations in emerging markets, auditors' responsibilities for addressing those risks, and certain other auditor responsibilities under PCAOB auditing standards. Local business practices and cultural norms in emerging markets may differ from those in more developed markets, and auditors should be alert to the effect of these differences on the risks of material misstatement. Auditors should focus on the audit procedures required to respond to those risks.

Fraud risks may be encountered in audits of companies in any region, whether the region is an emerging or developed market. Auditors have a responsibility to assess fraud risks in the financial statements that they audit and to perform audit procedures that respond to those risks, regardless of the regulatory environment.[2] The specific nature and characteristics of fraud risks, however, can vary depending upon, among other things, the environment in which the company operates, including the maturity and the robustness of the regulatory environments in the countries in which the company conducts its business activities.

Authorities in many emerging market countries are taking steps to improve investor protection. The PCAOB, however, has observed from its oversight

[1] According to information in the Statistical Appendix of International Monetary Fund *World Economic Outlook: Slowing Growth Rising Risks* (September 2011), emerging market countries accounted for over 40 percent of global gross domestic product in 2010.

[2] See paragraph 4 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* and paragraphs 3-4 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

activities some conditions in audits of certain companies in emerging markets that indicate heightened fraud risk. Other situations have come to light in recent corporate filings with the Securities and Exchange Commission ("SEC") and in SEC orders suspending trading in securities of certain companies in emerging markets. In just two months in 2011, more than 24 companies with their principal place of business in the People's Republic of China ("PRC") filed Forms 8-K with the SEC reporting auditor resignations, accounting irregularities, or both.[3] In some instances, the auditor's letter of resignation stated that the auditor resigned because of circumstances that could constitute illegal acts for purposes of Section 10A of the Securities Exchange Act of 1934 ("Exchange Act").[4] Since then the SEC's actions have expanded, including instituting stop order proceedings against two PRC-based companies.[5] Further, additional auditor resignations have occurred.[6]

Examples of conditions and situations indicating heightened fraud risk in certain companies in emerging markets that have been observed by PCAOB staff or reported in an SEC filing include:

- Existence of two separate and different sets of financial books and records;
- Discrepancies between the company's financial books and records and audit evidence obtained with respect to the existence and accuracy of cash balances, accounts receivable, and revenues;
- Auditor difficulties in confirming cash balances, including when requesting to visit the offices of the company's bank, or questions about the authenticity of bank statements provided to the auditor;
- Auditors' follow-up visits to bank offices indicating serious discrepancies between bank confirmations provided to the auditor and the bank's actual records, such as previously undisclosed material borrowings and no record of or significant differences regarding certain transactions;
- Attempts by management to intercept or alter confirmation requests or responses;
- Irregularities in sales contracts, such as a company-specific seal affixed on the sales contract that does not belong to the purported customer named in the contract;
- Recognizing revenue from contracts or customers whose existence could not be corroborated;
- Recording sales of products shipped to warehouses or freight forwarders where no customer is identified;
- Undisclosed material facts surrounding acquisition transactions, sales transactions, and off-balance-sheet transactions with related parties;

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[3] See letter from SEC Chairman Mary Schapiro, dated April 27, 2011, to the Chairman of the House Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs, Congressman Patrick McHenry, at http://s.wsj.net/public/resources/documents/BARRONS-SEC-050411.pdf.

[4] See the discussion in the section on illegal acts below.

[5] See SEC Press Release, Stop Order Proceedings Instituted Against China Intelligent Lightning and Electronics, Inc., and China Century Dragon Media, Inc. (June 13, 2011) at: http://www.sec.gov/news/press/2011/2011-127.htm.

[6] See, e.g., Longtop Financial Technologies Limited, Form 6-K (May 23, 2011), Exhibit 2 at: http://www.sec.gov/Archives/edgar/data/1412494/000095012311052882/d82501exv99w2.htm.

- Recording of assets for which evidence of control, ownership, or title is either unclear or difficult to corroborate;
- Potential double counting of fixed assets;
- Recording of uncorroborated operating expenses for which the business purpose is unclear;
- Manipulation of the accounting records to mischaracterize or conceal payment of bribes or other improper payments;
- Significant unexplained discrepancies between amounts included in the financial statements in SEC filings and amounts included in financial reports to other regulators, such as local authorities;
- Use of personal-type bank accounts held in the name of corporate officers or employees instead of corporate-type bank accounts for company business; and
- Unusual delays by management in the production of routine documents requested by the auditor.[7]

PCAOB standards require auditors to perform their audits to respond to fraud risks and other risks of material misstatement, and to obtain relevant and reliable evidence that is sufficient to support the auditor's opinion.[8] This practice alert discusses certain considerations that may be relevant when performing audits in emerging markets.

Although the conditions, situations, and fraud risks described in this alert have been observed in audits of companies in certain emerging markets, they might also be present at companies in other markets. The matters discussed in this alert are relevant whenever such conditions, situations, or fraud risks are present in audits of companies located in emerging or developed markets.

Consideration of Fraud is an Integral Part of the Audit

The consideration of fraud is an integral part of the audit under PCAOB standards. PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud.[9] The auditor should exercise professional skepticism, and "conduct the audit engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present."[10] PCAOB auditing standards related to the auditor's assessment of and response to risk[11] and AU sec. 316, collectively, describe the auditor's responsibilities for identification, assessment, and response to fraud risks.

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[7] In addition to indicating a heightened fraud risk, in some circumstances, the conditions and situations in this list also may be indications of illegal acts which are discussed in the section on illegal acts below.

[8] See, generally, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*; Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* Auditing Standard No. 13 and Auditing Standard No. 15, *Audit Evidence.*

[9] See paragraph 3 of Auditing Standard No. 8, *Audit Risk*.

[10] AU sec. 316.13.

[11] Auditing Standard No. 8, 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, Auditing Standard No. 13, Auditing Standard No. 14, *Evaluating Audit Results*, and Auditing Standard No. 15.

Identifying and Assessing Fraud Risk Factors[12]

Fraud risks may arise from a variety of sources, including external factors and internal factors. The auditor should perform risk assessment procedures[13] and evaluate whether the information gathered from those procedures indicates that one or more fraud risk factors are present and should be taken into account in identifying and assessing fraud risks.[14]

As part of risk assessment procedures, the auditor "should obtain an understanding of the company and its environment"[15] in order to "understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement."[16] This includes, for example, understanding:[17]

- The relevant industry and regulatory factors, including the legal, and political environment, which may include matters such as:
  - — The company's significance in the regional or local economy and its level of influence over its industry, and regional or local government, and
  - — Cultural norms in the business and regulatory environments;
- The company's objectives, strategies, and related business risks; its organizational structure; and sources of funding of the company's operations;
- The company's significant investments, including equity method investments, joint ventures, and variable interest entities ("VIEs");[18]
- The sources of the company's earnings, including the relative profitability of key products and services; and
- The company's key supplier and customer relationships.

Significant differences can exist between the business environments faced by companies with operations in emerging markets and those in developed markets, which may affect the risk of misstatement in the financial statements. For example, companies in emerging markets may be subject to rapidly changing or less consistent regulatory oversight and reporting requirements, whereas companies in developed markets may not.[19] These and other aspects of the

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[12] According to paragraph 65 of Auditing Standards 12, "[f]raud 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." See, generally, AU sec. 316.85.

[13] See paragraphs 4-58 of Auditing Standard No. 12, which describe risk assessment procedures the auditor should perform.

[14] See paragraphs 59-73 of Auditing Standard No. 12, which discuss identifying and assessing the risks of material misstatement, due to error or fraud, using information obtained from performing risk assessment procedures.

[15] Paragraph 7 of Auditing Standard No. 12.

[16] Ibid.

[17] See paragraphs 9-17 of Auditing Standard No. 12.

[18] See Subtopic 810-10 of the Financial Accounting Standards Board's Accounting Standards Codification for a definition of a variable interest entity.

[19] See, generally, Silvia Iorgova and Li Lian Ong *The Capital Markets of Emerging Europe: Institutions, Instruments and Investors*, IMF Working Paper WP/08/103 (April 2008), at: www.imf.org/external/pubs/ft/wp/2008/wp08103.pdf.

business environment in emerging markets can create incentives, pressures, and opportunities that may lead to a heightened risk of fraud.

Incentives and Pressures

As with public companies in developed countries, emerging market companies seeking to raise capital in international markets may wish to present a strong financial position and robust growth in revenue and earnings. In turn, this may create incentives or pressures to manipulate the financial statements rather than report poor results or bad news to the investing public. For example, if a company failed to consummate a previously announced acquisition, there is a risk that management might manipulate the financial statements to make them appear as though the acquisition has occurred. As another example, management at remotely located operating units of large multinational companies locations may feel pressure to report inflated results.

In addition to the incentives and pressures routinely considered in audits of public companies, auditors should consider any unique characteristics of the emerging market company or its environment that might result in specific fraud risks. For example, a company might engage in a significant business partnership with a state-owned entity or VIE. In that situation, the company might be motivated to consolidate the partnership or VIE to strengthen its reported financial position, even if significant legal restrictions prevent the company from obtaining a controlling interest in the partnership or assets. For instance, a company might enter into contractual arrangements with a VIE that are designed to enable the company to consolidate the VIE, even though there might be significant uncertainties regarding the economic substance of those arrangements.[20] As another example, legal restrictions on the movement of company assets might lead companies to maintain substantial amounts of cash or other liquid assets in business units in certain jurisdictions, which can create incentives for misappropriation of assets.

Opportunities

Some fraud risks arise when internal or external conditions and weak internal controls provide opportunities for management or employees of the company to engage in fraudulent activities. Certain aspects of the business environment in emerging markets can create opportunities to perpetrate fraud, as discussed in the examples below.

For example, a company in an emerging market might have a dominant presence in the geographic region in which it is located because it is the single largest employer in the region, or it may exercise control over raw materials on which other companies in the region depend. The company's management might have strong ties with the local or state government. In such circumstances:

- Management might be able to dictate terms or conditions to local suppliers or customers, which might result in non-arm's length transactions.
- Management might be able to pressure personnel of a local bank or other third parties to provide fraudulent information to the auditor.

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[20] Additionally, such VIE structures can result in increased risks related to omitted, incomplete, or inaccurate disclosures. See paragraphs 12-13 of Auditing Standard No. 12.

- Company employees might not be willing to report instances of fraud for cultural reasons or fear of retribution from management. While whistleblower protections have been introduced in many emerging market countries, observers have said that there is still a need to improve the effectiveness of the whistleblower programs.[21]

Additionally, weak internal controls and lack of robust governance mechanisms have been observed in companies in certain emerging market countries. This may stem from a lack of familiarity in local cultures with certain governance concepts, such as prohibition of self-dealing, even where similar legal concepts exist.[22] For example, such a culture might provide opportunities for management to influence other senior company officials or various third parties to provide false or misleading information to the company's auditors.

If criticizing or questioning a figure of authority is contrary to the local culture, the company's employees may be hesitant to express any concerns about management's actions to an auditor. Such an environment can provide additional opportunities for management to override controls or intentionally misstate the financial statements.[23]

As another example, a company in an emerging market might be created as a spin-off from a larger private or state-owned entity. The operating components of the larger entity may be among the company's largest suppliers or customers. In certain instances, the same individual or group that controls the company might also control the company's suppliers and customers.[24] Such situations might provide opportunities for management to:

- Enter into undisclosed side agreements with the related parties, or
- Collude with the related parties to create false documentation to support fictitious transactions.

Some emerging market companies employ as their chief financial officer ("CFO") an individual based in, or from, another region or country. Such a CFO might lack knowledge of the local language and the company's business practices and, therefore, might not be able to effectively perform certain important entity-level controls, thereby creating opportunities for company personnel to commit or conceal fraudulent misstatement of the financial statements. Similar conditions and risks may be present at significant subsidiaries of multi-national companies in emerging markets.

In some emerging market countries, controlling shareholders exercise strong oversight over executive management and foster a corporate culture focused on long-term value creation. In other jurisdictions, controlling shareholders have the opportunity to engage in abusive conduct, a problem that is magnified in jurisdictions where transparency is poor and where a weak rule of law fails to give minority investors proper judicial recourse.[25]

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[21] See Organization for Economic Cooperation and Development (OECD) *Corporate Governance in Asia 2011: Progress and Challenges*, Corporate Governance, OECD Publishing (2011), pg 36, at: http://dx.doi.org/10.1787/9789264096790-en.

[22] Ibid, pg 25.

[23] See AU sec. 316.08.

[24] See OECD *Guide on Fighting Abusive Related Party Transactions in Asia*, OECD Publishing (2009), pgs 9-12 and 14-16, at: www.oecd.org/dataoecd/39/57/43626507.pdf.

[25] See Melsa Ararat and George Dallas (International Finance Corporation), *Corporate Governance in Emerging Markets: Why it Matters to Investors – and What They Can Do About It*, Global Corporate Governance Forum (2011), pg 11, at: http://www.ifc.org/ifcext/cgf.nsf/Content/PSO_22_Melsa.

The Auditor's Response to Fraud Risks

PCAOB standards require that the auditor design and implement audit responses that address the identified and assessed fraud risks.[26] The auditor's responses should include responses that have an overall effect on how the audit is conducted (e.g., making appropriate engagement assignments) and responses involving the nature, timing, and extent of audit procedures (e.g., modifying the planned audit procedures).[27]

Under PCAOB standards, "[t]he 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."[28] Ineffective responses to fraud risks may result in the auditor's failure to detect material misstatement of the financial statements or failure to obtain sufficient appropriate audit evidence to support the opinion in the auditor's report. Examples of the application of professional skepticism in response to the assessed fraud risks may include "modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and ... obtaining sufficient appropriate evidence to corroborate management's explanations or representations."[29]

Performing Audit Procedures to Respond to Fraud Risks

The auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks, including certain procedures to address the risk of management override of controls.[30]

Many of the conditions discussed above that indicate heightened fraud risk appear to involve possible attempts to overstate the amounts of assets or revenues in the companies' financial statements. When performing audit procedures to address certain fraud risks, especially those involving the existence of assets such as cash and accounts receivable, it is important to obtain audit evidence through direct written communication with a knowledgeable third party who is objective and free from bias with respect to the audited entity.[31]

If, through the performance of risk assessment procedures, other audit procedures, or by other means, the auditor becomes aware of conditions that call for a heightened degree of professional skepticism with respect to the authenticity of documents, the auditor should perform additional procedures to determine that the reliability of evidence obtained in the course of the audit has not been compromised.[32] In such circumstances, it would be unlikely for auditors to rely solely on management-provided documentation without obtaining documentation directly from third parties to corroborate management's assertions.

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[26] See paragraph 3 of Auditing Standard No. 13.

[27] See Auditing Standard No. 13, which establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement.

[28] Paragraph 7 of Auditing Standard No. 13.

[29] Ibid.

[30] See paragraphs 13 and 15 of Auditing Standard No. 13. Additionally, as part of the auditor's response to the assessed risks of material misstatement due to fraud, the auditor should incorporate an element of unpredictability in the selection of auditing procedures to be performed. See paragraph 5c of Auditing Standard No. 13. Also, see paragraphs 14-15 of Auditing Standard No. 5.

[31] See paragraphs .26-.27 of AU sec. 330, *The Confirmation Process* and the section on confirmations below.

[32] See paragraph 9 of Auditing Standard No. 15.

Confirmations

To respond to fraud risks related to the company's accounts with a bank or amounts due from customers, it is important for the auditor to confirm amounts included in the company's financial statements directly with a knowledgeable individual from the bank or customer who is objective and free from bias with respect to the audited entity rather than rely solely on information provided by the company's management.[33] Under PCAOB standards, "[e]vidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources."[34]

Further, under PCAOB standards, the auditor "should maintain control over the confirmation requests and responses."[35] If the auditor identifies a risk that the company's management, or someone else at management's request, could attempt to intercept or alter the confirmation requests or responses, the auditor should maintain control over the confirmation process by taking actions aimed specifically at addressing that risk. For example, if the auditor uses a courier to expedite the delivery of confirmation requests, the courier should be reliable and independent from management to ensure that the confirmation requests are delivered directly to the intended recipient. If there is a heightened risk of management interference in the confirmation process, it might be necessary for the auditor to deliver the confirmation request personally and/or to observe the intended recipient of the confirmation request complete the response in order to communicate directly with an independent and knowledgeable source.

Also, the auditor should evaluate who the intended recipient of the confirmation request is and whether the company's management has any influence over this individual to provide false or misleading information to the auditor.[36] For example, if the company is the only or a significant customer or supplier of the confirming entity, the staff of that entity may be more susceptible to pressure from the company's management to falsify documentation provided to the auditor. As another example, the auditor might determine that confirmation responses cannot be relied upon if it appears that management interfered with the process because responses to confirmation requests were received from a personal e-mail account rather than a company network domain, or multiple confirmations are returned with similar handwriting and the same date, or confirmations returned from companies with different physical addresses contain mail stamps indicating same time processing.

If there is a heightened risk that the intended recipient is susceptible to management influence, the auditor should consider whether the response will provide meaningful and appropriate evidence and determine whether other procedures are necessary to obtain sufficient appropriate audit evidence.[37]

Revenue Recognition

Under PCAOB standards, "[t]he auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of

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[33] See AU sec. 330.34, which states that there is a presumption that the auditor will request the confirmation of accounts receivable during an audit except under certain conditions that are unlikely to be present when fraud risks are present. For example, one of those conditions, the auditor's combined assessed level of inherent and control risk is low, is unlikely to be the case when a fraud risk is present.

[34] Paragraph 8 of Auditing Standard No. 15. Also, AU secs. 330.26-.27 describe the auditor's responsibilities regarding confirmation with knowledgeable third parties who are objective and free from bias with respect to the audited entity.

[35] AU sec. 330.28.

[36] See AU sec. 330.26-.27.

[37] See paragraph 4 of Auditing Standard No. 15 and AU sec. 330.27.

revenue, revenue transactions, or assertions may give rise to such risks."[38] Management might use a variety of tools to attempt to overstate revenue or conceal improprieties in recording revenue, including entering into improper bill-and-hold transactions, generating invoices and customer contracts for non-existent transactions, altering original documentation, and establishing fake customers and mailing addresses.

To develop an effective response to such fraud risks, it is important for the auditor to obtain an understanding of the company and its environment, including the sources and composition of revenues; specific attributes of revenue transactions; the company's business and financial reporting processes regarding revenue and amounts due from customers; and unique industry considerations. Such an understanding is important in order for the auditor to consider the ways in which revenue could be fraudulently misstated in order to design appropriate audit procedures to detect those types of misstatements. Also, PCAOB standards require the auditor to gain an understanding of the business rationale for significant unusual transactions and whether that rationale (or the lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.[39]

Exercising professional skepticism requires the auditor to, among other things, perform procedures to obtain and critically evaluate evidence from all sources rather than rely solely on management representations about the company's performance.[40] For example, if the auditor performs an analytical procedure regarding revenue and management represents that a significant unexpected increase in revenue from the prior year results from increased production, the auditor should obtain evidence to corroborate this representation and critically evaluate whether the representation is reasonable based on the evidence obtained, such as, whether the company is capable of producing the additional output.[41]

While the auditor is not expected to be an expert in document authentication, the auditor should exercise professional skepticism in reviewing documentation obtained as audit evidence, especially documentation provided by the company. Under PCAOB standards, "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."[42] For example, if the auditor suspects that management has falsified sales documentation, the auditor should perform additional procedures, such as performing procedures to obtain documentation directly from the company's customers or suppliers to compare it to documents provided by management.

Transactions with Related Parties

It is not uncommon for companies in emerging markets to be owned or controlled by a small group of individuals or a family. These individuals often serve as the senior members of the company's management and also may control some of the

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[38] Paragraph 68 of Auditing Standard No. 12.

[39] See AU sec. 316.66.

[40] See paragraph 7 of Auditing Standard No. 13 and AU sec. 333.02-.04.

[41] See paragraphs 5-9 of Auditing Standard No. 14. When the auditor is performing an analytical procedure as a substantive test, see the requirements of AU sec. 329, *Substantive Analytical Procedures*.

[42] Paragraph 9 of Auditing Standard No. 15.

entities that the company does business with, such as customers or suppliers. Accordingly, transactions with related parties may play a significant role in the company's operations. The auditor, therefore, should be aware of a risk of undisclosed related party transactions or side agreements.

To obtain sufficient appropriate audit evidence with respect to related party transactions, an auditor should design and perform procedures that take into account the specific environment in which a company operates.[43] In addition, pursuant to section 10A(a)(2) of the Exchange Act, auditors are required to include "procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein."[44]

Some companies in emerging markets might have significant transactions with related entities that are not audited or are audited by another firm. For example, a company might purchase substantially all of its raw materials and utility services from or extend significant loans to a related unaudited entity. Paragraph A.2 of AU sec. 316.85 states in the Opportunities subsection that "significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm" constitute an example of a fraud risk factor that provides opportunities to engage in fraudulent financial reporting. Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions*, issued on April 7, 2010, describes certain requirements in PCAOB auditing standards regarding significant unusual transactions.[45]

Other Matters that Affect Fraud Risk

Under PCAOB standards, "the auditor should evaluate whether the accumulated results of auditing procedures 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."[46] Matters indicating a heightened risk of fraud may include, for example:[47]

- *Inconsistent, vague, or implausible responses from management* – In situations in which management fraudulently recorded nonexistent sales transactions, management's explanation of an unexpected increase in revenue may be vague or inconsistent with the auditor's understanding of the company's operations.
- *Conflicting or missing evidence* – Documents provided by management may appear to have been altered or have internal inconsistencies. The auditor should critically assess such inconsistencies and discrepancies to identify whether they are indicative of fraudulent activities by the company's management or employees. For example:
    - — The name of a third party on the letterhead of a confirmation response may be different from the name on a seal used to authenticate a signed document.

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[43] See AU sec. 334, *Related Parties*, which describes procedures for the auditor to perform "to identify related party relationships and transactions and to satisfy himself concerning the required financial statement accounting and disclosure."

[44] See 15 U.S.C. § 78j-1(a).

[45] Staff Audit Practice Alert No. 5 is located on the Board's web site at: http://pcaobus.org/Standards/QandA/04-07-2010_APA_5.pdf.

[46] Paragraph 28 of Auditing Standard No. 14.

[47] See Appendix C of Auditing Standard No. 14.

— Amounts confirmed by the local branch of a bank may be different from those confirmed by the bank headquarters.

— There may be conflicting or missing documentary support for the company's rights to assets.

- *Problematic relationships between the auditor and management* – To conceal fraudulent financial reporting, management might attempt to control the audit process by limiting the auditor's access to sources of audit evidence, such as the company's personnel or third parties. For example:

  — Management could request that the auditor send confirmation requests and receive replies through personnel of the company.

  — Management could instruct the bank not to respond to the auditor's request to confirm the company's cash, deposit, or loan payable balances with the bank.

  — Management engaged in fraudulent financial reporting might be unwilling to add or revise disclosures in the financial statements to make them more transparent.

  — Management engaged in fraudulent financial reporting might be unwilling to appropriately address significant deficiencies in internal control on a timely basis, e.g., before the end of a financial reporting period.

Under PCAOB standards, restrictions on the scope of the audit imposed by the company's management or by circumstances, such as – among other things – the inability to obtain sufficient appropriate evidence or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or to disclaim an opinion on the company's financial statements.[48]

Other Considerations

Client Acceptance and Continuance

Under PCAOB standards, client acceptance and continuance is a required element of quality control for an auditor.[49] This includes establishing policies and procedures to provide reasonable assurance that the auditor:

- "Undertakes only those engagements that the firm can reasonably expect to be completed with professional competence.
- Appropriately considers the risks associated with providing professional services in the particular circumstances."[50]

Conditions and situations previously described in this alert that indicate heightened fraud risk in companies with operations in emerging markets may also place additional demands on the auditor's professional competence. In performing acceptance and continuance assessments for clients with operations in emerging markets, the auditor should consider his or her own ability to perform audits in emerging markets and, if using the work of accountants outside the

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[48] See paragraph .22 of AU sec. 508, *Reports on Audited Financial Statements*. Also, Auditing Standard No. 5 provides direction regarding modifications to the auditor's report due to restrictions on the scope of the audit of internal control over financial reporting.

[49] See paragraph .07 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

[50] QC sec. 20.15.

auditor's own firm, the auditor's ability to supervise or assume responsibility for that work in accordance with PCAOB standards.

The PCAOB previously directed auditors' attention to the standards that apply to using the work of other auditors and engaging assistants from outside the firm – including auditors and assistants based outside the U.S. – in Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm* ("Practice Alert No. 6"), issued on July 12, 2010.[51] Practice Alert No. 6 noted, among other things, that the following factors may affect how an auditor plans and performs an audit of the financial statements of an issuer with substantially all of its operations outside of the U.S., including emerging market countries:

- Use of local audit firms or assistants from an outside firm to complete a portion of the audit work;
- The need to understand the local language;
- Additional travel time and expense necessary to complete an audit; and
- The need to understand the local business environment in which the client operates.

Making Engagement Assignments and Coordinating the Auditor's Response with Another Accounting Firm

PCAOB standards require that the knowledge, skill, and ability of engagement team members with significant engagement responsibilities, and the extent of supervision of engagement team members, be commensurate with the risks of material misstatement, including fraud risks.[52] The higher risk areas of the audit, including the areas of fraud risk, require more supervisory attention from the engagement partner. When the auditor uses the work of accountants outside the auditor's own firm, the auditor should take into account the knowledge, skill, and ability of each engagement team member from outside the firm.[53] Through the Board's oversight activities, the Board's staff has observed instances in certain audits of emerging market companies in which the engagement partner or other engagement team members inappropriately delegated to junior assistants the identification of audit issues, analysis of documents provided by the company, and certain communication with management and third parties; additionally, supervision by the auditor of the junior personnel was not in compliance with PCAOB standards.

In some situations, another independent accounting firm (including accounting firms affiliated with the same network as the auditor) performs an audit of and issues a report on one or more of the company's subsidiaries, divisions, branches, components, or investments. The auditor should inquire about the professional reputation of the other auditor and adopt other appropriate measures, e.g., ascertaining that the other auditor is familiar with the relevant financial reporting requirements and PCAOB standards.[54] PCAOB inspection

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[51] Practice Alert No. 6 is located on the Board's web site at: http://pcaobus.org/Standards/QandA/2010-07-12_APA_6.pdf

[52] See paragraph 6 of Auditing Standard No. 10 and paragraph 5 of Auditing Standard No. 13. If the auditor uses as assistants personnel of another accounting firm or individual accountants not employed by an accounting firm, the auditor should follow the same requirements as for supervising assistants from the auditor's own firm.

[53] See paragraph 6 of Auditing Standard No. 10.

[54] See paragraph .10 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

reports, when available, may provide the auditor with relevant information.[55] The auditor should adopt appropriate measures to assure the coordination of the auditor's activities with those of the other auditor, including the audit procedures performed in response to fraud risks.[56] Through the Board's oversight activities, the Board's staff has observed instances in certain audits of companies in emerging markets in which the auditor did not properly coordinate the audit with another auditor. When significant parts of the audit are performed by other auditors, the auditor must decide whether the auditor's own participation in the audit is sufficient.[57]

Making appropriate engagement assignments and coordinating the auditor's response with another auditor necessarily entails overcoming any language barriers. In some audits of companies in emerging markets, key engagement team members[58] might be from outside the country in which substantially all of the company's operations, its top management, or the other auditor is located. In those circumstances, the auditor should take the necessary steps to enable effective communication among the engagement team members, effective communication between the auditor and the company's personnel or the other auditor, and effective review of documentation prepared in a foreign language.[59]

Individual accountants or accounting firms that participate in the audit from the same region where the company is located (the "local accountants") may be aware of local customs, cultural norms, and business practices that have an impact on the company's corporate governance and business activities. When planning and performing the audit, the auditor should discuss such matters with the local accountants and determine whether any of these matters affect fraud risks. The auditor should discuss with the local accountants identified fraud risks and determine that appropriate steps are taken to respond to these risks.[60]

Illegal Acts

During the course of an audit, the auditor may determine that violations of laws or government regulations by company management or employees may constitute illegal acts, as defined by AU sec. 317, *Illegal Acts by Clients,*[61] and

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[55] According to PCAOB Rule 2100, each public accounting firm that (a) prepares or issues any audit report with respect to any issuer; or (b) plays a substantial role in the preparation or furnishing of an audit report with respect to any issuer must be registered with the Board. The Board publishes on its Web site a list that names every registered firm that has triggered an inspection requirement under PCAOB Rule 4003 and notes whether the firm has ever been inspected. See http://pcaobus.org/Inspections/Pages/InspectedFirms.aspx. In addition, the Board has published on its Web site a listing of issuer audit clients of non-U.S. registered firms in jurisdictions where the PCAOB had been denied access to conduct inspections. See http://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx.

[56] See AU sec. 543.10, and AU sec. 316.53.

[57] See AU sec. 543.02.

[58] The term "key engagement team members" includes all engagement team members who have significant engagement responsibilities, including the engagement partner. See paragraph 50 of Auditing Standard No. 12.

[59] See paragraph 5 of Auditing Standard No. 10 and AU sec. 543.10.

[60] See paragraph 5 of Auditing Standard No. 10, paragraphs 51-52 of Auditing Standard No. 12, and AU sec. 316.53.

[61] See AU sec. 317.02. For example, even though not fraud, a violation of the books and records provisions of the Foreign Corrupt Practices Act ("FCPA"), Exchange Act sections 13(b)(2) through (b)(7), would be an illegal act as defined in AU sec. 317. These FCPA provisions generally require

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section 10A of the Exchange Act.[62] AU sec. 317 describes the considerations an auditor should give to the possibility of illegal acts as well as the auditor's responsibilities when a possible illegal act is detected. In addition, pursuant to section 10A(a)(1) of the Exchange Act, auditors are required to perform procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of the financial statement amounts.[63] The auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud.[64]

When the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements, as well as the implications for other aspects of the audit, such as the reliability of representations of management.[65] The implications of particular illegal acts will depend on the relationship of the perpetration and concealment, if any, of the illegal act to specific control procedures, and the level of management or employees involved.[66] The auditor should also evaluate the adequacy of disclosure in the financial statements of the potential effects of an illegal act on the entity's operations.[67] If the illegal act results in uncorrected misstatements of even relatively small amounts, it further could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.[68] If the auditor concludes that an illegal act has or is likely to have occurred, AU sec. 317 requires that the auditor, among other things, determine "that the audit committee, or others with equivalent authority and responsibility, is adequately informed with respect to [the] illegal acts."[69]

Section 10A(b) of the Exchange Act imposes additional requirements that apply when the auditor "detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements) has or may have occurred."[70]

Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, describes procedures that "should be followed by the auditor who,

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(footnote continued)

issuers with securities registered under section 12 of the Exchange Act or required to file reports under section 15(d) of the Exchange Act, among other things, to make and keep books and records that fairly reflect the transactions and assets of the issuer and to devise and maintain internal accounting controls sufficient to permit the preparation of financial statements in conformity with the applicable financial reporting framework.

[62] See 15 U.S.C. § 78j-1(a).

[63] Ibid.

[64] See AU 317.05.

[65] See AU sec. 317.10 and .16. See also section 13(b)(2) of the Exchange Act.

[66] See AU sec. 317.16.

[67] See AU sec. 317.15.

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

[69] AU sec. 317.17.

[70] See 15 U.S.C. § 78j-1(b).

subsequent to the date of the [audit report], becomes aware that facts may have existed at that date which might have affected the report had he or she then been aware of such facts."[71] The auditor should follow the requirements of AU sec. 561 if, subsequent to the date of the audit report, the auditor becomes aware of information indicating the possibility of fraudulent financial reporting.

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[71] AU sec. 561.01.

.09 Staff Audit Practice Alert No. 9

Assessing and Responding to Risk in the Current Economic Environment

December 6, 2011

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the standards and rules of the PCAOB and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts do not establish rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Background

In December 2008, Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* ("Practice Alert No. 3"),[1] was issued to assist auditors in identifying matters related to the then-current economic environment that might affect the risk of material misstatement of issuers' financial statements and the related auditor's responsibilities under Public Company Accounting Oversight Board ("PCAOB" or "the Board") standards.

Since the issuance of Practice Alert No. 3, economic conditions have been slower to recover than many had originally anticipated.[2] Uncertainty continues regarding global economic conditions, and certain volatility indicators are higher than they were before the financial crisis. In September 2011, the International Monetary Fund ("IMF") reduced its estimate of 2012 global growth from 4.5%, which was provided in June 2011, to 4% and, at the same time, reduced its 2012 growth forecast for U.S. growth from 2.7% to 1.8%.[3]

In November 2011, the Federal Reserve Board also reduced its projections for short- and longer-term GDP while increasing its estimated unemployment rate.[4] While countries work toward addressing their economic challenges,

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[1] *See* Staff Audit Practice Alert No. 3 on the Board's web site at: http://pcaobus.org/Standards/QandA/12-5-2008_APA_3.pdf.

[2] For example, in August 2011, the Congressional Budget Office reported that "[a]lthough economic output began to expand again two years ago, the pace of the recovery has been slow, and the economy remains in a severe slump." Congress of the United States Congressional Budget Office, "*The Budget and Economic Outlook: An Update*" (August 2011).

[3] On September 15, 2011, Christine Lagarde, Managing Director of the IMF, said "[o]verall, global growth is continuing, but slowing down. The advanced countries in particular are facing an anemic and bumpy recovery, with unacceptably high unemployment." The full text of Ms. Lagarde's speech is available at: http://www.imf.org/external/np/speeches/2011/091511.htm.

[4] *See* Federal Reserve Board "*Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, November 2011,*" available at: http://www.federalreserve.gov/newsevents/press/monetary/20111102b.htm.

market volatility continues, and economic conditions may vary significantly among different regions or sectors of the economy.

Difficult economic conditions may affect companies' operations and financial reporting and, in turn, may have implications for audits of financial statements and internal control over financial reporting. Matters discussed in Practice Alert No. 3, such as auditing fair value measurements, auditing accounting estimates, the auditor's consideration of a company's ability to continue as a going concern, and auditing financial statement disclosures, continue to be critical in the current economic environment.

Although many of the risks discussed in Practice Alert No. 3 continue to have relevance, a number of the auditing standards referenced in that alert regarding the auditor's assessment of and response to risk were superseded in 2010 when the Board adopted a suite of eight new auditing standards ("risk assessment standards").[5] The risk assessment standards, which enhance the effectiveness of the auditor's assessment of and response to risk of material misstatement in an audit, became effective for audits of fiscal years beginning on or after December 15, 2010. As compared to the Board's interim standards, the risk assessment standards, among other things, establish enhanced requirements pertaining to the performance of risk assessment procedures, provide additional factors relevant to identifying significant risks, and enhance requirements for auditing financial statement disclosures. Auditors should be alert to the new requirements contained in the risk assessment standards and how those requirements relate to audits performed in the current economic climate.

The purpose of this staff audit practice alert is to assist auditors in identifying matters related to the current economic environment that might affect the risk of material misstatement and, therefore, require additional audit attention. The practice alert discusses certain issues posed by the current economic environment, highlights certain requirements in the risk assessment standards, and is organized into four sections:

- Considering the impact of economic conditions on the audit;
- Auditing fair value measurements and estimates;
- The auditor's consideration of a company's ability to continue as a going concern; and
- Auditing financial statement disclosures.

While the alert highlights certain issues, it is not intended to identify all issues that might affect audit risk in the current economic environment or serve as a substitute for the relevant auditing standards. All audits of issuers must be conducted in accordance with the standards of the PCAOB.

Considering the Impact of Economic Conditions on the Audit

As year-end approaches for many issuers, changing economic conditions might require the auditor to reassess the appropriateness of the planned audit strategy, materiality levels, risk assessments (including identified fraud risks and other significant risks), and planned audit responses. Such a reassessment is especially important if the auditor planned the audit and performed the initial

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

risk assessment procedures early in the year or performed initial testing as of or through an interim date.

Audit Planning and Materiality Considerations

Audit planning is not a discrete phase of an audit but, rather, a continual and iterative process.[6] The nature and extent of planning activities that are necessary depend on, among other things, changes in circumstances that occur during the audit.[7] Accordingly, the auditor should modify the overall audit strategy and the audit plan as necessary if circumstances change significantly during the course of the audit.[8] For example, in an audit of the financial statements of a company with operations in multiple locations, changes in regional economic conditions might alter the risks associated with certain locations, which in turn, could affect the selection of locations for testing or determination of extent of testing at selected locations.[9]

The current economic environment may also require the auditor to re-evaluate the established materiality level or levels and tolerable misstatement (e.g., if the auditor initially established the materiality level or levels and tolerable misstatement based on estimated or preliminary financial statement amounts that differ significantly from actual amounts).[10] 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.[11] If so, the auditor should establish separate materiality levels for those accounts or disclosures to plan the nature, timing, and extent of audit procedures.[12] For example, this might be appropriate if certain financial statement line items are particularly important to a regulatory requirement or a debt covenant.

Risk Assessment

The effectiveness of a risk-based audit approach is dependent on the ability of the auditor to identify the risks of material misstatement and to have an appropriate basis for assessing those risks. 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, including the auditor's responsibilities for performing risk assessment procedures.

Examples of risk assessment procedures that may provide particularly relevant information in identifying and assessing the risks of material misstatement in the current economic environment include, among other things:

- Reading public information about the impact of the current economic environment on the company, including, for example, analyst reports and company-issued press releases.[13]

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[6] *See* paragraph 5 of Auditing Standard No. 9, *Audit Planning*.

[7] *See* paragraph 7 of Auditing Standard No. 9.

[8] *See* paragraph 15 of Auditing Standard No. 9.

[9] *See* paragraphs 11–14 of Auditing Standard No. 9.

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

[11] Paragraph 7 of Auditing Standard No. 11.

[12] Ibid.

[13] *See* paragraph 11 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

- Obtaining an understanding of the company's performance measures (including, for example, performance measures that form the basis for contractual commitments or incentive compensation arrangements or measures used by external parties, such as analysts and rating agencies, to review the company's performance).[14] When slowdowns in a company's market or industry reduce the likelihood that a company will meet its consensus earnings estimate, there could be additional pressure on management to manipulate the financial statements to achieve this estimate.[15]
- Obtaining an understanding of a company's current and prospective financing requirements. In the current economic environment, companies may not be able to regularly access funds through short-term borrowings, may have other liquidity issues, such as significant collateral calls or a lack of acceptable collateral, may be at risk of violating debt covenants, or may have significant tranches of debt becoming due within one year. In such cases, companies may be unable to settle their obligations as they become due. In turn, this situation could affect the risks of material misstatement related to, for example, 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.[16]
- Performing analytical procedures designed to 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 identify areas that might represent specific risks relevant to the audit.[17] When performing an analytical procedure, the auditor should use his or her understanding of the company to develop expectations about plausible relationships among the data to be analyzed.[18]

The risk assessment standards include requirements for the auditor to incorporate knowledge obtained during past audits and interim reviews into the auditor's process for identifying risks of material misstatement; however, in a changing economic environment, the auditor should evaluate whether the prior years' information remains relevant and reliable.[19] For example, when performing an analytical procedure in the current economic environment, prior period financial information may not be an appropriate data point in developing an expectation.

The risk assessment standards also require the auditor's assessment of the risks of material misstatement to continue throughout the audit.[20] For example, significant changes in industry or market conditions near year-end, such as a sovereign debt rating downgrade in a market in which a company has a concentration of customers, might provide audit evidence that contradicts the evidence on which the auditor originally based his or her risk assessments regarding the valuation of assets. In such cases, the auditor should revise the

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[14] *See* paragraphs 16-17 of Auditing Standard No. 12.

[15] *See*, for example, paragraph 52 of Auditing Standard No. 12 and paragraph .85 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

[16] *See* paragraph 14-15 of Auditing Standard No. 12.

[17] *See* paragraph 46 of Auditing Standard No. 12.

[18] *See* paragraph 48 of Auditing Standard No. 12.

[19] *See* paragraphs 42-44 of Auditing Standard No. 12.

[20] *See* paragraph 74 of Auditing Standard No. 12.

risk assessments and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.[21]

Communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change.[22] For instance, the results of the "brainstorming" discussion among the key engagement team members about how and where they believe the company's financial statements might be susceptible to material misstatement due to fraud may need to be updated to reflect additional fraud risks that could result from the specific effects of the current economic environment on the company.[23]

Identifying Fraud Risks and Other Significant Risks

In identifying and assessing risks of material misstatement, 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.[24] Staff Audit Practice Alert No. 8, *Audit Risks in Certain Emerging Markets* ("Practice Alert No. 8"), issued in October 2011, focuses on fraud risks that auditors might encounter in audits of companies with operations in emerging markets and auditors' responsibilities for addressing those risks.[25] While the focus of Practice Alert No. 8 was on emerging markets, fraud risks may be encountered in audits of companies in any region, especially when the company is faced with challenging economic conditions. In addition, auditors are reminded that their consideration of fraud includes misstatements from the misappropriation of assets.[26]

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.[27] Incentives or pressures to perpetrate fraud may exist when:

- Financial stability or profitability is threatened by economic conditions. For example, in the current economic environment, a company with substantial direct or indirect sovereign debt exposure may be motivated to not consider all relevant market information when determining a fair value measurement or enter into off-balance sheet arrangements that fail to be appropriately accounted for or disclosed.[28]
- Excessive pressure exists for management to meet the requirements or expectations of third parties (e.g., due to expectations created by management in, for example, press releases or annual report messages that are no longer realistic).

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[21] Ibid.

[22] Paragraph 51 of Auditing Standard No. 12.

[23] *See* paragraph 52 of Auditing Standard No. 12.

[24] Paragraph 65 of Auditing Standard No. 12.

[25] *See* Staff Audit Practice Alert No. 8 on the Board's web site at: http://pcaobus.org/Standards/Pages/Guidance.aspx.

[26] *See* AU sec. 316.06.

[27] Paragraph 65 of Auditing Standard No. 12.

[28] Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions,* discussed audit considerations regarding significant transactions that are outside the normal course of business for a company, or that otherwise appear to be unusual given the auditor's understanding of the company and its environment. *See* Staff Audit Practice Alert No. 5 on the Board's website at: http://pcaobus.org/Standards/QandA/04-07-2010_APA_5.

- There is excessive pressure on operating personnel, including, for example, operating personnel in remote locations, to meet financial targets set by management, including sales or profitability incentive goals.[29]

In identifying and assessing risks of material misstatement, the auditor should determine whether any of the auditor's identified and assessed risks are significant risks.[30] A significant risk is defined as "[a] risk of material misstatement that requires special audit consideration."[31] To determine whether a 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.[32] One of the factors that should be evaluated in determining which risks are significant risks is whether the risk is related to recent significant economic developments.[33] Accordingly, risks of material misstatement that may be particularly susceptible to changes in the economic environment should be evaluated in this context. Other factors that the auditor should evaluate in determining significant risks include:[34]

- 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;
- 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; and
- Whether the risk involves significant transactions with related parties. Transactions with related parties may be motivated solely, or in large measure, by conditions such as a lack of sufficient working capital or credit to continue the business, an overly optimistic earnings forecast, or a declining industry characterized by a large number of business failures.[35]

Planned Audit Responses

When the identified and assessed risks of material misstatement change, corresponding changes to planned audit responses may be necessary to adequately address the assessed risks.[36] Depending on the circumstances, these changes may need to be pervasive.[37] An example of such a pervasive change includes modifying the audit strategy to increase the substantive testing of the valuation of numerous significant accounts at year-end because of significant volatility in market conditions.[38]

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[29] AU sec. 316.85 A.2 describes further examples of risk factors relating to misstatements arising from fraudulent financial reporting.

[30] *See* paragraph 59f of Auditing Standard No. 12.

[31] Paragraph A5 of Appendix A to Auditing Standard No. 12.

[32] *See* paragraph 70 of Auditing Standard No. 12.

[33] *See* paragraph 71 of Auditing Standard No. 12.

[34] Ibid.

[35] *See* paragraph .06 of AU sec. 334, *Related Parties*.

[36] *See* paragraph 3 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

[37] *See* paragraph 6 of Auditing Standard No. 13.

[38] Ibid.

For significant risks, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.[39] Accordingly, for significant risks, the auditor's substantive procedures should include tests of details that are specifically responsive to the assessed risks.[40]

When using an analytical procedure as a substantive test, the expected effectiveness of the procedure depends on, among other things, the plausibility and predictability of relationships among financial and non-financial data.[41] As higher levels of assurance are desired from analytical procedures that are used as substantive procedures, more predictable relationships are required to develop the expected analytical relationships.[42] Relationships in a stable environment are usually more predictable than relationships in a dynamic or unstable environment.[43]

When testing controls over relevant assertions in an audit, the auditor should evaluate whether the controls are designed and operating effectively.[44] Practice Alert No. 3 discussed matters that may require additional auditor attention regarding the effective operation of internal controls, including job eliminations that may increase the risk of deficiencies in internal control over financial reporting because of, for example, lack of segregation of duties or lack of effective monitoring controls.

Auditing Fair Value Measurements and Estimates

The current economic environment continues to present challenges relating to auditing fair value measurements and estimates.[45] When auditing accounting estimates, the auditor should perform procedures to determine whether the accounting estimates are determined in conformity with the applicable financial reporting framework, are reasonable, and do not result in bias that materially misstates the financial statements.[46] When testing management's process for determining fair value measurements or estimates, the auditor should perform procedures commensurate with the related risk, including considering whether significant assumptions are best supported by the available audit evidence.[47] For example:

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[39] *See* paragraph .09 of AU sec. 329, *Substantive Analytical Procedures*.

[40] *See* paragraph 11 of Auditing Standard No. 13.

[41] *See* AU sec. 329.11.

[42] *See* AU sec. 329.14.

[43] Ibid.

[44] *See*, for example, paragraphs 16-22 of Auditing Standard No. 13.

[45] Fair value measurements and estimates were the subject of a number of audit deficiencies noted in the Board's Rule 4010 *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis* (available at: http://pcaobus.org/Inspections/Documents/4010_Report_Economic_Crisis.pdf). In addition, fair value measurements and estimates were discussed in a number of previous staff audit practice alerts. See Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, Practice Alert No. 3, Staff Audit Practice Alert No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments*, and Staff Audit Practice Alert No. 7, *Auditor Considerations of Litigation and Other Contingencies Arising from Mortgage and Other Loan Activities*. Staff Audit Practice Alerts are available at: http://pcaobus.org/Standards/Pages/Guidance.aspx.

[46] *See*, for example, paragraph 23 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, paragraph .11 of AU sec. 342, *Auditing Accounting Estimates*, and paragraphs 13 and 24-27 of Auditing Standard No. 14, *Evaluating Audit Results*.

[47] Ibid.

- Significant assumptions used in fair value measurements and estimates that are based on past experience and management expectations, such as revenue projections, cash flow estimates, charge-off rates, or projected rate of return assumptions and discount rates used in determining pension liabilities, may not reflect current market information or be representative of expected future conditions or events.
- Reductions in forecasts of macro-economic growth or extended periods of low interest rates may affect important assumptions underlying certain estimates, such as impairment determinations or the valuation of servicing assets. Uncertainty regarding the value of certain types of collateral or increasing counter-party risk may affect the valuation of financial instruments.
- Additional risks, such as sovereign default risk or currency volatility, could add a higher level of complexity in determining the ultimate collectability of sales or the appropriateness of other significant assumptions used in certain fair value determinations or estimates, including the fair value of certain financial instruments.
- An active market may not exist for certain financial instruments which in turn may result in complex valuation methods. Assumptions are integral components of more complex valuation methods, for example, valuation methods that employ a combination of estimates of expected future cash flows together with estimates of the values of assets or liabilities in the future, discounted to the present. Auditors pay particular attention to the significant assumptions underlying a valuation method and evaluate whether such assumptions are reasonable and reflect, or are not inconsistent with, market information.[48]

Auditors are reminded that audit evidence consists of both information that supports and corroborates management's assertions and information that contradicts such assertions including assertions regarding fair values, estimates and related disclosures.[49]

Bias in Accounting Estimates

Business conditions today may create increased pressures to achieve certain financial results that could result in bias in management's estimates.[50] Applying professional skepticism is of particular importance when evaluating estimates and assumptions in judgmental areas that are susceptible to management bias.

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.[51] A lack of consistency in assumptions used to support different estimates might be indicative of errors or bias in estimates. For instance, revenue assumptions used in the goodwill impairment test that are inconsistent with revenue assumptions used to accrue discretionary compensation might be indicative of management bias. Further, bias might be evidenced by assumptions that are inconsistent with industry economic forecasts or the

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[48] AU sec. 328.29.

[49] *See* paragraph 2 of Auditing Standard No. 15, *Audit Evidence*.

[50] *See* paragraph 25d of Auditing Standard No. 14.

[51] Paragraph 27 of Auditing Standard No. 14.

company's budgets or future business plans or the consistent use of overly optimistic assumptions (e.g. consistently missing projected revenue by a substantial amount in each recent period).[52] If each accounting estimate included in the financial statements is individually reasonable but the effect of the difference between each estimate and the estimate best supported by the audit evidence is to increase earnings or loss, the auditor should evaluate whether these circumstances indicate potential management bias in the estimates.[53] 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.[54]

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.[55] 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.[56] Auditors are reminded that indications of management bias in accounting estimates and in selecting accounting principles may affect the auditor's conclusions about the operating effectiveness of controls and should be included in the auditor's evaluation of controls in an integrated audit.[57]

Consideration of Changes to Accounting Standards

Practice Alert No. 3 provided information on selected financial reporting areas that might be affected by the then-current economic environment. While these areas continue to pose audit and financial reporting risk, certain accounting requirements have been amended since the issuance of Practice Alert No. 3.[58] For example, the Financial Accounting Standards Board ("FASB") recently issued Accounting Standards Codification Update 2011-08, *Intangibles-Goodwill and Others (Topic 350): Testing Goodwill for Impairment* ("ASU No. 2011-08").[59] That guidance allows companies to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350.[60]

If a company opts to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more

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[52] *See*, for example, AU sec. 342.09.

[53] Paragraph 27 of Auditing Standard No. 14.

[54] Ibid.

[55] Paragraph 26 of Auditing Standard No. 14.

[56] Ibid.

[57] *See* paragraph B8 of Appendix B to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements*.

[58] The Board has no authority to prescribe the form or content of a company's financial statements. That authority, and the authority to make binding determinations concerning compliance with generally accepted accounting standards ("GAAP"), rests with the U.S. Securities and Exchange Commission. Accordingly, while this staff audit practice alert describes applicable GAAP, it does not establish or interpret GAAP.

[59] *See* http://www.fasb.org/cs/ContentServer?site=FASB&c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1176156316498.

[60] ASU No. 2011-08 at 1.

likely than not that the fair value of a reporting unit is less than its carrying amount, ASU No. 2011-08 provides examples of events and circumstances that the company should consider in its evaluation.[61] These examples include, among others:

- Macroeconomic conditions such as a deterioration in general economic conditions;
- Limitations on accessing capital;
- Fluctuations in foreign exchange rates, or other developments in equity and credit markets; and
- Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (considered in both absolute terms and relative to peers), a change in the market for an entity's products or services, or a regulatory or political development.[62]

When reviewing and testing the process for a company's assessment of qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value, audit considerations include, among others:

- Identifying the sources of data and factors that the company used in forming the assumptions, and consideration of whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests.
- Considering whether there are additional key factors or alternative assumptions about the factors.
- Evaluating whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.
- Considering whether changes in the business or industry may cause other factors to become significant to the assumptions.[63]

The Auditor's Consideration of a Company's Ability to Continue as a Going Concern

Practice Alert No. 3 noted certain challenges companies may face in their ability to continue operating as a going concern in light of the then-current economic environment. These challenges included a reduction of the availability of funding under lines of credit or from short-term borrowing markets, difficulty in meeting debt covenants, and a lack of acceptable collateral. Some companies may continue to face such challenges in the current economic environment.

The auditor has a responsibility to evaluate whether there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements

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[61] ASU No. 2011-08 at 2.

[62] ASU No. 2011-08, paragraph 350-20-35-3c.

[63] *See* AU sec. 342.11.

being audited.[64] The auditor's going concern evaluation can affect the auditor's evaluation of financial disclosures and the auditor's report.[65]

The auditor's going concern evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report.[66] Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited, as described in Auditing Standard No. 15, *Audit Evidence*.[67]

Conditions or events, such as negative trends and other indications of possible financial difficulties as well as internal and external matters that have occurred, when considered in the aggregate, may indicate there could be substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.[68] If the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the auditor should (1) obtain information about management's plans that are intended to mitigate the effect of such conditions or events, and (2) assess the likelihood that such plans can be effectively implemented.[69]

Management's plans for dealing with the adverse effects of the conditions or events may include the disposal of assets, borrowing additional funds or restructuring existing debt, planned reduction of expenditures, or increasing equity by raising capital.[70] When evaluating management's plans, the auditor should identify those elements that are particularly significant to overcoming the adverse effects of the conditions and events and should plan and perform auditing procedures to obtain evidential matter about them.[71]

In the current economic environment, it is important for the auditor to consider the adequacy of support for such plans,[72] including whether it is likely that the adverse effects will be mitigated for a reasonable period of time and whether the plans can be effectively implemented.[73] For example, if management indicates that the company plans to dispose of assets to raise capital, audit considerations may include the existence of any restrictions on the disposal of the assets, issues related to the marketability of the assets, and any possible direct or indirect effects of disposal of the assets.[74] As another example, if management is relying on a pledge of financial support from a significant shareholder, consideration should be given to the impact of current economic conditions on the shareholder's ability to provide such funding.[75] Another important consideration in the current economic environment is the willingness of a third party to

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[64] Paragraph .02 of AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

[65] *See* AU secs. 341.12 and 341.14.

[66] AU sec. 341.02.

[67] *See* paragraph 11 of Auditing Standard No. 15.

[68] *See* AU sec. 341.06.

[69] AU sec. 341.03.b.

[70] *See* AU sec. 341.07.

[71] AU sec. 341.08.

[72] Ibid.

[73] *See* AU sec. 341.07.

[74] Ibid.

[75] Such consideration may include information contained in, among other things, the audited financial statements of the shareholder, reports issued by regulatory agencies, financial publications, or credit agencies concerning the shareholder, and income tax returns of the shareholder, to the extent available.

continue to provide financial support, especially if the third party has already provided support to ongoing operations or in light of a potentially longer time frame for the company to return to profitability or positive cash flow.

When prospective financial information is particularly significant to management's plans, the auditor should request management to provide that information and should consider the adequacy of support for significant assumptions underlying that information.[76] In considering the adequacy of support for significant assumptions, the auditor should consider whether the assumptions are consistent with current economic conditions, such as, recent reductions in economic growth forecasts and information obtained by the auditor in other audit areas.

In the current economic environment, assumptions that are especially sensitive or susceptible to change and that are important to the auditor's evaluation of whether or not substantial doubt remains about the company's ability to continue as a going concern may warrant particularly careful consideration by the auditor.[77] When, primarily because of the consideration of management's plans, the auditor concludes that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time is alleviated, the auditor should consider the need for disclosure in the financial statements, the principal conditions and events that initially caused him or her to believe there was substantial doubt, including the possible effects of such conditions and events, and any mitigating factors, including management's plans.[78]

Auditing Financial Statement Disclosures

The risk assessment standards recognize the importance of financial statement disclosures by directing the auditor's attention to them throughout the audit process. The current economic environment may increase the risk related to omitted, incomplete, or inaccurate disclosures, including, for example, disclosures regarding contingent liabilities, risks and uncertainties, concentrations of credit risk, and liquidity concerns.

The risk assessment standards require auditors to perform procedures to assess the risk of omitted, incomplete, or inaccurate disclosures, whether intentional or unintentional,[79] and to identify and test significant disclosures.[80] To identify and assess such risks, 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.[81] 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.[82] The discussion among the key engagement

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[76] AU sec. 341.09.

[77] Ibid.

[78] *See* AU sec. 341.11.

[79] *See*, for example, paragraphs 49, 52, and 67 of Auditing Standard No. 12.

[80] *See*, for example, paragraphs 59–64 of Auditing Standard No. 12 and paragraph 9 and footnote 6 of Auditing Standard No. 13. A disclosure is a significant disclosure if there is a reasonable possibility that the disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements. *See* paragraph A10 of Auditing Standard No. 5.

[81] *See* paragraph 12 of Auditing Standard No. 12.

[82] Paragraph 49 of Auditing Standard No. 12.

team members should include how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures.[83]

The nature of certain financial statement disclosure requirements, the complexity of the matters disclosed, and the qualitative nature of certain disclosures can pose additional risks of material misstatement. Also, internal controls over disclosures that are qualitative, judgmental, or complex often are different from those controls over the processing and reporting of routine historical transactions. For these types of disclosures, the necessary controls are more likely to be manual controls than automated controls and may require significant judgment in the operation of the control, which, in turn, can affect the risk associated with the control.

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

- Evaluating whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation;[84] and
- Considering the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.[85]

Evaluation of disclosures also involves evaluation of the effect on the financial statements of uncorrected misstatements in disclosures, such as omitted, incomplete, or inaccurate disclosures. Qualitative considerations are particularly important when evaluating misstatements in disclosures that are more narrative in nature, such as those relating to risks and uncertainties or loss contingencies where an estimate has not yet been disclosed.[86] PCAOB auditing standards describe the auditor's responsibilities for considering qualitative factors in the context of the auditor's consideration of materiality.[87]

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, among other things, the nature of the assigned work for each engagement team member, including the controls or accounts and disclosures to be tested.[88] For example, additional supervision over audit areas including disclosures that are more qualitative, judgmental, or complex in nature may be merited. Also, to effectively evaluate those disclosures, auditors need to exercise professional skepticism and be alert for events or conditions that may contradict management's assertions in the disclosures.[89] Events or conditions that may contradict information in the disclosures may arise during the performance of other audit procedures including reading information in documents containing audited financial statements or may be based

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[83] *See* paragraph 52 of Auditing Standard No. 12.

[84] *See* paragraph .04 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.*

[85] *See* paragraph 31 of Auditing Standard No. 14.

[86] Practice Alert No. 3 discussed communications with audit committee, including communications about the clarity and completeness of the financial statements, that include related disclosures.

[87] *See*, for example, paragraph 24 and Appendix B of Auditing Standard No. 14.

[88] *See* paragraph 6b(2) of Auditing Standard No. 10, *Supervision of the Audit Engagement.*

[89] *See* AU sec. 230, *Due Professional Care in the Performance of Work*.

on more general factors, such as conditions in the industry in which the company operates. PCAOB standards require auditors to read other information in documents containing audited financial statements and consider whether such information is materially inconsistent with information appearing in the financial statements, including disclosures.[90]

Obtaining audit evidence that is relevant for evaluating disclosures that are more judgmental or qualitative in nature might require different auditing procedures from those used to evaluate disclosures of routine historical data. For example, the evidence needed to evaluate a disclosure relating to a loss contingency might come from sources outside the company's accounting system or possibly from sources outside the company.

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[90] *See* paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

.10 Staff Audit Practice Alert No. 10

Maintaining and Applying Professional Skepticism in Audits

December 4, 2012

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the standards and rules of the PCAOB and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts do not establish rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Executive Summary

Professional skepticism is essential to the performance of effective audits under Public Company Accounting Oversight Board ("PCAOB" or "Board") standards. Those standards require that professional skepticism be applied throughout the audit by each individual auditor on the engagement team.

PCAOB standards define professional skepticism as an attitude that includes a questioning mind and a critical assessment of audit evidence. The standards also state that professional skepticism should be exercised throughout the audit process. While professional skepticism is important in all aspects of the audit, it is particularly important in those areas of the audit that involve significant management judgments or transactions outside the normal course of business. Professional skepticism also is important as it relates to the auditor's consideration of fraud in an audit. When auditors do not appropriately apply professional skepticism, they may not obtain sufficient appropriate evidence to support their opinions or may not identify or address situations in which the financial statements are materially misstated.

Observations from the PCAOB's oversight activities continue to raise concerns about whether auditors consistently and diligently apply professional skepticism. Certain circumstances can impede the appropriate application of professional skepticism and allow unconscious biases to prevail, including incentives and pressures resulting from certain conditions inherent in the audit environment, scheduling and workload demands, or an inappropriate level of confidence or trust in management. Audit firms and individual auditors should be alert for these impediments and take appropriate measures to assure that professional skepticism is applied appropriately throughout all audits performed under PCAOB standards.

Firms' quality control systems can help engagement teams improve the application of professional skepticism in a number of ways, including setting a proper tone at the top that emphasizes the need for professional skepticism; implementing and maintaining appraisal, promotion, and compensation processes

that enhance rather than discourage the application of professional skepticism; assigning personnel with the necessary competencies to engagement teams; establishing policies and procedures to assure appropriate audit documentation, especially in areas involving significant judgments; and appropriately monitoring the quality control system and taking necessary corrective actions to address deficiencies, such as, instances in which engagement teams do not apply professional skepticism.

The engagement partner is responsible for, among other things, setting an appropriate tone that emphasizes the need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, so that, for example, engagement team members have the confidence to challenge management representations. It is also important for the engagement partner and other senior engagement team members to be actively involved in planning, directing, and reviewing the work of other engagement team members so that matters requiring audit attention, such as unusual matters or inconsistencies in audit evidence, are identified and addressed appropriately.

It is the responsibility of each individual auditor to appropriately apply professional skepticism throughout the audit, including in identifying and assessing the risks of material misstatement, performing tests of controls and substantive procedures to respond to the risks, and evaluating the results of the audit. This involves, among other things, considering what can go wrong with the financial statements, performing audit procedures to obtain sufficient appropriate audit evidence rather than merely obtaining the most readily available evidence to corroborate management's assertions, and critically evaluating all audit evidence regardless of whether it corroborates or contradicts management's assertions.

The Office of the Chief Auditor is issuing this practice alert to remind auditors of the requirement to appropriately apply professional skepticism throughout their audits. The timing of this release is intended to facilitate firms' emphasis in upcoming calendar year-end audits, as well as in future audits, on the importance of the appropriate use of professional skepticism. Due to the fundamental importance of the appropriate application of professional skepticism in performing an audit in accordance with PCAOB standards, the PCAOB also is continuing to explore whether additional actions might meaningfully enhance auditors' professional skepticism.

Professional Skepticism and Due Professional Care

Professional skepticism, an attitude that includes a questioning mind and a critical assessment of audit evidence, is essential to the performance of effective audits under PCAOB standards. The audit is intended to provide investors with an opinion on whether the financial statements prepared by company management are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. If the audit is conducted without professional skepticism, the value of the audit is impaired.

The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.[1] This responsibility includes obtaining sufficient appropriate evidence to determine whether the financial

[1] Paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*.

statements are materially misstated rather than merely looking for evidence that supports management's assertions.[2]

PCAOB standards require the auditor to exercise due professional care in planning and performing the audit and in preparing the audit report. Due professional care requires the auditor to exercise professional skepticism. PCAOB standards define professional skepticism as an attitude that includes a questioning mind and a critical assessment of audit evidence. PCAOB standards require the auditor to exercise professional skepticism throughout the audit.[3]

While professional skepticism is important in all aspects of the audit, it is particularly important in those areas of the audit that involve significant management judgments or transactions outside the normal course of business, such as nonrecurring reserves, financing transactions, and related party transactions that might be motivated solely, or in large measure, by an expected or desired accounting outcome. Effective auditing involves diligent pursuit of sufficient appropriate audit evidence, particularly if contrary evidence exists, and critical assessment of all the evidence obtained.

Professional skepticism is also important as it relates to the auditor's consideration of fraud in the audit.[4] Company management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information.[5] Company personnel who intentionally misstate the financial statements often seek to conceal the misstatement by attempting to deceive the auditor. Because of this incentive, applying professional skepticism is integral to planning and performing audit procedures to address fraud risks. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest.[6]

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.[7]

PCAOB inspectors continue to observe instances in which the circumstances suggest that auditors did not appropriately apply professional skepticism in their audits.[8] As examples, audit deficiencies like the following raise concerns that a lack of professional skepticism was at least a contributing factor:

- For certain hard-to-value Level 2 financial instruments, the engagement team did not obtain an understanding of the specific methods and/or assumptions underlying the fair value estimates that were obtained from pricing services or other third parties and

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[2] *See, e.g.,* paragraph 3 of Auditing Standard No. 8, *Audit Risk* and paragraph 3 of Auditing Standard No. 14, *Evaluating Audit Results*.

[3] *See* paragraphs .01 and .07-.08 of AU sec. 230, *Due Professional Care in the Performance of Work*.

[4] *See* paragraph .13 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

[5] AU sec. 316.08.

[6] *See* AU secs. 230.07-.09.

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

[8] The PCAOB is not alone in identifying concerns regarding professional skepticism in audits. Regulators in countries such as Australia, Canada, Germany, the Netherlands, Singapore, Switzerland, and the United Kingdom have cited concerns about professional skepticism in public

(continued)

used in the engagement team's testing related to these financial instruments. Further, the firm used the price closest to the issuer's recorded price in testing the fair value measurements, without evaluating the significance of differences between the other prices obtained and the issuer's prices.

- The issuer discontinued production of a significant product line during the prior year and introduced a new product line to replace it. There were no sales of the discontinued product line during the last nine months of the year under audit. The engagement team did not test, beyond inquiry, the significant assumptions management used to calculate its separate inventory reserve for this product line.
- The engagement team did not evaluate the effects on the financial statements of management's determination not to test a significant portion of its property and equipment for impairment, despite indicators that the carrying amount may not have been recoverable. These indicators in this situation included operating losses for the relevant segment for the last three years, substantial charges for the impairment of goodwill and other intangible assets during the year, a projected loss for the segment for the upcoming year, and reduced and delayed customer orders.
- After the date of the issuer's balance sheet, but before the release of the firm's opinion, the issuer reported that it anticipated that comparable store sales for the first quarter of the year would be significantly lower than those for the first quarter of the year under audit. The engagement team had performed sensitivity analyses as part of its assessment on the issuer's evaluation of its compliance with its debt covenants, the issuer's ability to continue as a going concern, and the possibility of the impairment of the issuer's long-lived assets. The engagement team did not consider the implications of the anticipated decline in sales on its sensitivity analyses and its conclusions with respect to compliance with debt covenants, the issuer's ability to continue as a going concern, and impairment of long-lived assets.

The PCAOB's enforcement activities also have identified instances in which auditors did not appropriately apply professional skepticism. For example, in one recent disciplinary order, the Board found, among other things, that certain of a firm's audit partners accepted a company's reliance on an exception to generally accepted accounting principles ("GAAP") requirements for reserving for expected future product returns even though doing so conflicted with the plain language of the exception and the firm's internal accounting literature. The partners were aware of, but did not appropriately consider, contradictory audit

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(footnote continued)

reports on their inspections. *See, e.g.,* the Financial Reporting Council's *Audit Quality Inspections Annual Report 2011/12*, available at http://www.frc.org.uk/Our-Work/Publications/AIU/Audit-Quality-Inspections-Annual-Report-2011-12.aspx, the Canadian Public Accountability Board's, *Meeting the Challenge "A Call to Action" 2011 Public Report*, available at http://www.cpab-ccrc.ca/en/content/2011Public_Report_EN.pdf, the Australian Securities & Investments Commission's Report 242, *Audit inspection program public report for 2009–2010*, available at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep242-published-29-June-2011.pdf/$file/rep242-published-29-June-2011.pdf, and the Accounting and Corporate Regulatory Authority *Practice Monitoring Programme Sixth Public Report*, August 2012, available at http://www.acra.gov.sg/NR/rdonlyres/E7E2A4BF-EC46-4AB2-877D-297D4E618042/0/PMPReport2012170712finalclean.pdf.

evidence indicating that the returns were not eligible for the exception. This illustration of a lack of professional skepticism reappeared in the firm's response when the issue was questioned by the firm's internal audit quality reviewers. Although certain of the partners involved determined that the company's reliance on the exception to GAAP did not support the company's accounting, they, along with other firm personnel, formulated another equally deficient rationale that supported the company's existing accounting result.[9]

Impediments to the Application of Professional Skepticism

Although PCAOB standards require auditors to appropriately apply professional skepticism throughout the audit, observations from the PCAOB's oversight activities indicate that, as a practical matter, auditors are often challenged in meeting this fundamental audit requirement. In maintaining an attitude that includes a questioning mind and a critical assessment of audit evidence, it is important for auditors to be alert to unconscious human biases and other circumstances that can cause auditors to gather, evaluate, rationalize, and recall information in a way that is consistent with client preferences rather than the interests of external users.

Certain conditions inherent in the audit environment can create incentives and pressures that can serve to impede the appropriate application of professional skepticism and allow unconscious bias to prevail. For example, incentives and pressures to build or maintain a long-term audit engagement, avoid significant conflicts with management, provide an unqualified audit opinion prior to the issuer's filing deadline, achieve high client satisfaction ratings, keep audit costs low, or cross-sell other services can all serve to inhibit professional skepticism.

In addition, over time, auditors may sometimes develop an inappropriate level of trust or confidence in management, which may lead auditors to accede to inappropriate accounting. In some situations, auditors may feel pressure to avoid potential negative interactions with, or consequences to, individuals they know (that is, management) instead of representing the interests of the investors they are charged to protect.

Other circumstances also can impede the appropriate application of professional skepticism. For example, scheduling and workload demands can put pressure on partners and other engagement team members to complete their assignments too quickly, which might lead auditors to seek audit evidence that is easier to obtain rather than evidence that is more relevant and reliable, to obtain less evidence than is necessary, or to give undue weight to confirming evidence without adequately considering contrary evidence.

Although powerful incentives and pressures exist that can impede professional skepticism, the importance of professional skepticism to an effective audit cannot be overstated, particularly given the increasing judgment and complexity in financial reporting and issues posed by the current economic environment.[10] Auditors and audit firms must remember that their overriding duty is to put the interests of investors first. Appropriate application of professional skepticism is key to fulfilling the auditor's duty to investors. In the words of the U.S. Supreme Court:

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[9] *See In the Matter of Ernst & Young LLP, Jeffrey S. Anderson, CPA, Ronald Butler, Jr., CPA, Thomas A. Christie, CPA, and Robert H. Thibault, CPA, Respondents*, PCAOB Release No. 105-2012-001, (Feb. 8, 2012).

[10] *See* Staff Practice Alert No. 9, *Assessing and Responding to Risk in the Current Economic Environment* (Dec. 6, 2011).

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[11]

However, inadequate performance of audit procedures may be caused by factors other than the lack of skepticism, or in combination with a lack of skepticism. As discussed further below, firms should take appropriate steps to understand the various factors that influence audit quality, including those circumstances and pressures that can impede the application of professional skepticism.

Promoting Professional Skepticism via an Appropriate System of Quality Control

PCAOB standards require firms to establish a system of quality control to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality.[12] This includes designing and implementing policies and procedures that lead engagement teams to appropriately apply professional skepticism in their audits.

Firms' quality control systems can help engagement teams improve the application of professional skepticism in a number of ways, including the following:

- *"Tone-at-the-Top" Messaging.* The PCAOB's inspection findings have identified instances in which the firm's culture allows or tolerates audit approaches that do not consistently emphasize the need for professional skepticism. Consistent communication from firm leadership that professional skepticism is integral to performing a high quality audit, backed up by a culture that supports it, could improve the quality of work performed by audit partners and staff. On the other hand, messages from firm leadership that are excessively focused on revenue or profit growth over achieving audit quality, can undermine the application of professional skepticism.
- *Performance Appraisal, Promotion, and Compensation Processes.* An audit firm's performance appraisal, promotion, and compensation processes can enhance or detract from the application of professional skepticism in its audit practice, depending on how they are designed and executed. For example, if a firm's promotion process emphasizes selling non-audit services or places an undue focus on reducing audit costs, or retaining and acquiring audit clients over achieving high audit quality, the firm's personnel may perceive those goals as being more important to their own compensation, job security, and advancement within the firm than the appropriate application of professional skepticism.
- *Professional Competence and Assigning Personnel to Engagement Teams*. A firm's quality control system depends heavily on the proficiency of its personnel,[13] which includes their ability to exercise

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[11] *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984).

[12] *See* paragraph .03 of Quality Control ("QC") sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

[13] QC sec. 20.11.

professional skepticism. To perform the audit with professional skepticism, it is important that personnel assigned to engagement teams have the necessary knowledge, skill, and ability required in the circumstances,[14] which includes appropriate technical training and experience. Professional skepticism is interrelated with an auditor's training and experience, as auditors need an appropriate level of competence in order to appropriately apply professional skepticism throughout the audit. In addition, it is important for the firm's culture to continually reinforce the appropriate application of professional skepticism throughout the audit.

- *Documentation*. It is important for a firm's quality control system to establish policies and procedures that cover documenting the results of each engagement.[15] Although documentation should support the basis for the auditor's conclusions concerning every relevant financial statement assertion, areas that require greater judgment generally need more extensive documentation of the procedures performed, evidence obtained, and rationale for the conclusions reached. In addition to the documentation necessary to support the auditor's final conclusions, audit documentation must include information the auditor has identified relating to significant findings or issues that is inconsistent with or contradicts the auditor's final conclusions.[16]
- *Monitoring.* Under PCAOB standards, a firm's quality control policies and procedures should include an element of monitoring to ensure that quality control policies and procedures are suitably designed and being effectively applied.[17] If the firm identifies deficiencies, the firm should evaluate the reasons for the deficiencies and determine the necessary corrective actions or improvements to the quality control system.[18] Accordingly, if a firm identifies deficiencies that include failures to appropriately apply professional skepticism as a contributing factor, the firm should take appropriate corrective actions.

Importance of Supervision to the Application of Professional Skepticism

The supervisory activities performed by the engagement partner and other senior engagement team members are important to the application of professional skepticism.[19] The engagement partner is responsible for the proper supervision of the work of engagement team members.[20] Accordingly, the engagement partner is responsible for setting an appropriate tone that emphasizes the need

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[14] *See* QC sec. 20.12.

[15] *See* QC secs. 20.17-.18. Also, *see generally* Auditing Standard No. 3, *Audit Documentation.*

[16] *See, e.g.,* paragraphs 7-8 of Auditing Standard No. 3.

[17] *See* QC sec. 20.07 and paragraph .02 of QC sec. 30, *Monitoring a CPA Firm's Accounting and Auditing Practice*.

[18] *See* QC sec. 30.03.

[19] Besides supervision by the engagement partner and other engagement team members, the engagement quality reviewer also plays an important role in assessing the application of professional skepticism by the engagement team. In particular, the engagement quality reviewer is required to perform specific procedures to evaluate the significant judgments made by the engagement team.

[20] Paragraph 3 of Auditing Standard No. 10, *Supervision of the Audit Engagement*.

to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, so that, for example, engagement team members have the confidence to challenge management representations.[21]

It is also important for the engagement partner and other senior engagement team members to be actively involved in planning, directing, and reviewing the work of other engagement team members so that matters requiring audit attention are identified and addressed appropriately. In directing the work of others, senior engagement team members, including the engagement partner, may have knowledge and experience that may assist less experienced engagement team members in applying professional skepticism. For example, senior engagement team members might help more junior auditors identify matters that are unusual or inconsistent with other evidence. In addition, senior members of the engagement team might be better able to challenge the assertions of senior levels of management, when necessary.

Appropriate Application of Professional Skepticism

Although a firm's quality control systems and the actions of the engagement partner and other senior engagement team members can contribute to an environment that supports professional skepticism, it is ultimately the responsibility of each individual auditor to appropriately apply professional skepticism throughout the audit, including the following areas among others:

- Identifying and assessing risks of material misstatement;
- Performing tests of controls and substantive procedures; and
- Evaluating audit results to form the opinion to be expressed in the auditor's report.

Identifying and Assessing Risks of Material Misstatement

By its nature, risk assessment involves looking at internal and external factors to determine what can go wrong with the financial statements, whether due to error or fraud. When properly applied, the risk assessment approach set forth in PCAOB standards should focus auditors' attention on those areas of the financial statements that are higher risk and thus most susceptible to misstatement. This includes considering events and conditions that create incentives or pressures on management or create opportunities for management to manipulate the financial statements. The evidence obtained from the required risk assessment procedures should provide a reasonable basis for the auditor's risk assessments, which, in turn, should drive the auditor's tests of accounts and disclosures in the financial statements.

The risk assessment procedures required by PCAOB standards also should provide the auditor with a thorough understanding of the company and its environment as a basis for identifying unusual transactions or matters that warrant further investigation. They also provide a basis for the auditor to evaluate and challenge management's assertions.[22] It is important to note that the auditor's understanding should be based on actual information obtained from the risk assessment procedures. It is not sufficient for auditors merely to rely on

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[21] *See* paragraph 53 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

[22] For example, risk assessment procedures may provide the auditor a basis for challenging management's responses to the required inquiries of management in Auditing Standard No. 12.

their perceived knowledge of the industry or information obtained from prior audits or other engagements for the company.

Performing Tests of Controls and Substantive Procedures

Appropriately applying professional skepticism is critical to obtaining sufficient appropriate audit evidence to determine whether the financial statements are free of material misstatement and, in an integrated audit, whether internal controls over financial reporting are operating effectively. Application of professional skepticism is not merely obtaining the most readily available evidence to corroborate management's assertion.

The need for auditors to appropriately apply professional skepticism is echoed throughout PCAOB standards. For example, PCAOB standards caution that representations from management are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit.[23] Also, the standards warn that inquiry alone does not provide sufficient appropriate evidence to support a conclusion about a relevant assertion.[24]

In addition, PCAOB standards require auditors to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement and to obtain more persuasive evidence the higher the assessment of risk.[25] The auditor is required to apply professional skepticism, which includes a critical assessment of the audit evidence.[26] Substantive procedures generally provide persuasive evidence when they are designed and performed to obtain evidence that is relevant and reliable.[27] When discussing the characteristics of reliable audit evidence, PCAOB standards observe that generally, among other things, evidence obtained from a knowledgeable source independent of the company is more reliable than evidence obtained only from internal company sources and evidence obtained directly by the auditor is more reliable than evidence obtained indirectly.[28]

Taken together, this means that in higher risk areas, the auditor's appropriate application of professional skepticism should result in procedures that are focused on obtaining evidence that is more relevant and reliable, such as evidence obtained directly and evidence obtained from independent, knowledgeable sources.[29] Further, if audit evidence obtained from one source is inconsistent with that obtained from another, 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.[30]

The following are examples of audit procedures in PCAOB standards that reflect the need for professional skepticism:

- Resolving inconsistencies in or doubts about the reliability of confirmations;[31]

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[23] *See* paragraph .02 of AU sec. 333, *Management Representations*.

[24] Paragraph 39 of Auditing Standard No. 13.

[25] *See* paragraphs 8-9 of Auditing Standard No. 13. For fraud risks and significant risks, the auditor also is required to perform procedures, including tests of details, that are specifically responsive to the assessed risks.

[26] *See* AU sec. 230.07.

[27] Paragraph 39 of Auditing Standard No. 13.

[28] *See* paragraph 8 of Auditing Standard No. 15, *Audit Evidence*.

[29] *See* paragraph 9.a. of Auditing Standard No. 13.

[30] Paragraph 29 of Auditing Standard No. 15.

[31] *See, e.g.,* paragraphs .27 and .33 of AU sec. 330, *The Confirmation Process*.

- Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud;[32]
- Reviewing accounting estimates for biases that could result in material misstatement due to fraud;[33]
- Evaluating the business rationale for significant unusual transactions;[34] and
- Evaluating whether there is substantial doubt about an entity's ability to continue as a going concern.[35]

Evaluating Audit Results to Form the Opinion to be Expressed in the Audit Report

When professional skepticism is applied appropriately, the auditor does not presume that the financial statements are presented fairly in conformity with the applicable financial reporting framework. Instead, the auditor employs an attitude that includes a questioning mind in making critical assessments of the evidence obtained to determine whether the financial statements are materially misstated. PCAOB standards indicate that the auditor should take into account all relevant audit evidence, regardless of whether the evidence corroborates or contradicts the assertions in the financial statements.[36] Examples of areas in the evaluation that reflect the need for the auditor to apply professional skepticism, include, but are not limited to, the following:

- *Evaluating uncorrected misstatements*. This includes evaluating whether the uncorrected misstatements identified during the audit result in material misstatement of the financial statements, individually or in combination, considering both qualitative and quantitative factors.[37]
- *Evaluating management bias.* This includes evaluating potential bias in accounting estimates, bias in the selection and application of accounting principles, the selective correction of misstatements identified during the audit, and identification by management of additional adjusting entries that offset misstatements accumulated by the auditor.[38] When evaluating bias, it is important for auditors to consider the incentives and pressures on management to manipulate the financial statements.
- *Evaluating the presentation of the financial statements.* This includes evaluating whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework.[39]

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[32] *See* AU secs. 316.58-.62.

[33] *See* AU secs. 316.63-.65.

[34] *See* AU secs. 316.66-.67.

[35] *See* AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

[36] *See* paragraph 3 of Auditing Standard No. 14.

[37] *See* paragraph 17 of Auditing Standard No. 14.

[38] *See* paragraph 25 of Auditing Standard No. 14.

[39] *See* paragraphs 30-31 of Auditing Standard No. 14.

When evaluating misstatements, bias, or presentation and disclosures, it is important for auditors to appropriately apply professional skepticism and avoid dismissing matters as immaterial without adequate consideration.

Conclusion

The Office of the Chief Auditor is issuing this practice alert to remind auditors of the requirement to appropriately apply professional skepticism throughout their audits, which includes an attitude of a questioning mind and a critical assessment of audit evidence. The timing of this release is intended to facilitate firms' emphasis in upcoming calendar year-end audits, as well as in future audits, on the importance of the appropriate use of professional skepticism. Due to the fundamental importance of the appropriate application of professional skepticism in performing an audit in accordance with PCAOB standards, the PCAOB also is continuing to explore whether additional actions might meaningfully enhance auditors' professional skepticism.

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PCAOB STAFF GUIDANCE TOPICAL INDEX

References are to section and paragraph numbers and to "Q" for specific Staff Questions and Answers.

A

C

D

E

S

T

Select Rules of the Board

Notice: This section is not a complete presentation of the PCAOB's *Rules of the Board*. Certain PCAOB rules and forms that are not directly related to conducting an audit of financial statements have been excluded (for example, rules concerning inspections and investigations are excluded from this section). You can access the PCAOB website (http://pcaobus.org/Rules/Pages/default.aspx) to view those excluded rules and forms.

SELECT RULES OF THE BOARD

TABLE OF CONTENTS

SECTION 1.
GENERAL PROVISIONS

Rule 1001. Definitions of Terms Employed in Rules.

When used in the Rules, unless the context otherwise requires:

(a)(i) Accounting Support Fee

The term "accounting support fee" means the fee described in Rule 7100.

[Effective pursuant to SEC Release No. 34-48278, File No. PCAOB-2003-02 (August 1, 2003)]

(a)(ii) Accountant

The term "accountant" means a natural person—

(1) who is a certified public accountant, or

(2) who holds—

(i) a college, university, or higher professional degree in accounting, or

(ii) a license or certification authorizing him or her to engage in the business of auditing or accounting, or

(3) who—

(i) holds a college, university, or higher professional degree in a field, other than accounting, and

(ii) participates in audits;

provided, however, that the term "accountant" does not include a person engaged only in clerical or ministerial tasks.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(a)(iii) Act

The term "Act" means the Sarbanes-Oxley Act of 2002.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(a)(iv) Associated Entity

The term "associated entity" means, with respect to a public accounting firm –

(1) any entity that directly, indirectly, or through one or more intermediaries, controls, or is controlled by, or is under common control with, such public accounting firm; or

(2) any "associated entity," as used in Rule 2-01(f)(2) of Regulation SX, 17 C.F.R. 210.2-01(f)(2), that would be considered part of that firm for purposes of the Commission's auditor independence rules.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(a)(v) Audit

The term "audit" means an examination of the financial statements of any issuer by an independent public accounting firm in accordance with the rules of the Board or the Commission (or, for the period preceding the adoption of

applicable Rules of the Board under Section 103 of the Act, in accordance with then applicable generally accepted auditing standards for such purposes), for the purpose of expressing an opinion on such statements.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(a)(vi) Audit Report

The term "audit report" means a document or other record—

(1) prepared following an audit performed for purposes of compliance by an issuer with the requirements of the securities laws; and

(2) in which a public accounting firm either—

(i) sets forth the opinion of that firm regarding a financial statement, report or other document; or

(ii) asserts no such opinion can be expressed.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(a)(vii) Audit Services

The term "audit services" means—

(1) subject to paragraph (a)(vii)(2) of this Rule, professional services rendered for the audit of an issuer's annual financial statements, and (if applicable) for the reviews of an issuer's financial statements included in the issuer's quarterly reports.

(2) effective after December 15, 2003, professional services rendered for the audit of an issuer's annual financial statements, and (if applicable) for the reviews of an issuer's financial statements included in the issuer's quarterly reports or services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements for those fiscal years.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(a)(viii) Auditing and Related Professional Practice Standards.

The term "auditing and related professional practice standards" means the auditing standards, related attestation standards, quality control standards, ethical standards, and independence standards (including any rules implementing Title II of the Act), and any other professional standards, that are established or adopted by the Board under Section 103 of the Act.

[Effective pursuant to SEC Release No. 34-48730, File No. PCAOB-2003-05 (October 31, 2003)]

(a)(ix) Accounting Board Demand

The term "accounting board demand" means a command to produce documents and/or to appear at a certain time and place to give testimony.

[Effective pursuant to SEC Release No. 34-49704, File No. PCAOB-2003-07 (May 14, 2004)]

(a)(x) Accounting Board Request

The term "accounting board request" means a request to produce documents and/or to appear at a certain time and place to give testimony.

[Effective pursuant to SEC Release No. 34-49704, File No. PCAOB-2003-07 (May 14, 2004)]

(a)(xi) Appropriate State Regulatory Authority

The term "appropriate state regulatory authority" means the State agency or other authority responsible for the licensure or other regulation of the practice of accounting in the State or States having jurisdiction over a registered public accounting firm or associated person thereof, with respect to the matter in question.

[Effective pursuant to SEC Release No. 34-49787, File No. PCAOB-2003-08 (June 1, 2004)]

(a)(xii) Auditor

The term "auditor" means both public accounting firms registered with the Public Company Accounting Oversight Board and associated persons thereof.

[Effective pursuant to SEC Release No. 34-50331, File No. PCAOB-2004-06 (September 8, 2004)]

(b)(i) Board

The term "Board" means the Public Company Accounting Oversight Board.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(b)(ii) Bar

The term "bar" means a permanent disciplinary sanction prohibiting a person from being associated with a registered public accounting firm.

[Effective pursuant to SEC Release No. 34-49704, File No. PCAOB-2003-07 (May 14, 2004)]

(c)(i) Commission

The term "Commission" means the Securities and Exchange Commission.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(c)(ii) Counsel

The term "counsel" means an attorney at law admitted to practice, and in good standing, before the Supreme Court of the United States or the highest court of any state.

[Effective pursuant to SEC Release No. 34-49704, File No. PCAOB-2003-07 (May 14, 2004)]

(d)(i) Disciplinary Proceeding

The term "disciplinary proceeding" means a proceeding initiated by an order instituting proceedings, held for the purpose of determining whether or not a registered public accounting firm, or any person associated with a registered public accounting firm, has engaged in any act or practice, or omitted to act, in violation of the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards; or has failed reasonably to supervise an associated person in connection with any such violation by that person; or has failed to cooperate with the Board in connection with an investigation; and whether to impose a sanction pursuant to Rule 5300.

[Effective pursuant to SEC Release No. 34-49704, File No. PCAOB-2003-07 (May 14, 2004)]

(d)(ii) Document

The term "document" is synonymous in meaning and equal in scope to its usage in Federal Rule of Civil Procedure 34(a), including, without limitation, electronic or computerized data compilations. A draft or non-identical copy is a separate document within the meaning of this term. In no event shall the term "document" be construed to be limited to audit work papers.

[Effective pursuant to SEC Release No. 34-49704, File No. PCAOB-2003-07 (May 14, 2004)]

(e)(i) Exchange Act

The term "Exchange Act" means the Securities Exchange Act of 1934, as amended.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(f)(i) Foreign Public Accounting Firm

The term "foreign public accounting firm" means a public accounting firm that is organized and operates under the laws of a non-U.S. jurisdiction, government or political subdivision thereof.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(f)(ii) Foreign Registered Public Accounting Firm

The term "foreign registered public accounting firm" means a foreign public accounting firm that is a registered public accounting firm.

[Effective pursuant to SEC Release No. 34-50291, File No. PCAOB-2004-04 (August 30, 2004)]

(h)(i) Hearing Officer

The term "hearing officer" means a person, other than a Board member or staff of the interested division, duly authorized by the Board to preside at a hearing.

[Effective pursuant to SEC Release No. 34-49704, File No. PCAOB-2003-07 (May 14, 2004)]

(i)(i) Issuer Market Capitalization

The terms "issuer market capitalization" and "market capitalization of an issuer" mean—

(1) Except as provided in paragraph (i)(i)(2) of this rule, the aggregate market value of all classes of an issuer's common stock that trade in the United States; or

(2) With respect to an issuer: (i) that is registered under Section 8 of the Investment Company Act or has elected to be regulated as a business development company pursuant to Section 54 of the Investment Company Act, and (ii) whose securities are not traded on a national securities exchange or quoted on Nasdaq, the issuer's net asset value.

[Effective pursuant to SEC Release No. 34-48278, File No. PCAOB-2003-02 (August 1, 2003)]

(i)(ii) Investment Company Act

The term "Investment Company Act" means the Investment Company Act of 1940, as amended.

[Effective pursuant to SEC Release No. 34-48278, File No. PCAOB-2003-02 (August 1, 2003)]

(i)(iii) Issuer

The term "issuer" means an issuer (as defined in Section 3 of the Exchange Act), the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d) of that Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(i)(iv) Interested Division

The term "interested division" means a division or office of the Board assigned primary responsibility by the Board to participate in a particular proceeding.

[Effective pursuant to SEC Release No. 34-49704, File No. PCAOB-2003-07 (May 14, 2004)]

(n)(i) Notice

The term "notice" means the document sent by the Board to an issuer, pursuant to Rule 7102, setting forth such issuer's share of the accounting support fee under Section 109 of the Act and Rules 7101 and 7102.

[Effective pursuant to SEC Release No. 34-48278, File No. PCAOB-2003-02 (August 1, 2003)]

(n)(ii) Non-Audit Services

The term "non-audit services" means—

(1) subject to paragraph (n)(ii)(2) of this Rule, services related to financial information systems design and implementation as defined in Rule 2-01(c)(4)(ii) of Regulation S-X, 17 C.F.R. 2-01(c)(4)(ii), and all other services, other than audit services or other accounting services.

(2) effective after December 15, 2003, all other services other than audit services, other accounting services, and tax services.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(n)(iii) Non-U.S. Inspection

The term "non-U.S. inspection" means an inspection of a foreign registered public accounting firm conducted within a non-U.S. oversight system.

[Effective pursuant to SEC Release No. 34-50291, File No. PCAOB-2004-04 (August 30, 2004)]

(o)(i) Other Accounting Services

The term "other accounting services" means—

(1) subject to paragraph (o)(i)(2) of this Rule, services that are normally provided by the public accounting firm that audits the issuer's financial statements in connection with statutory and regulatory filings or engagements and assurance and related services that are reasonably related to the performance of the audit or review of the issuer's financial statements, other than audit services.

(2) effective after December 15, 2003, assurance and related services that are reasonably related to the performance of the audit or

review of the issuer's financial statements, other than audit services.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(o)(ii) Order Instituting Proceedings

The term "order instituting proceedings" means an order issued by the Board commencing a disciplinary proceeding.

[Effective pursuant to SEC Release No. 34-49704, File No. PCAOB-2003-07 (May 14, 2004)]

(p)(i) Person Associated With a Public Accounting Firm (and Related Terms)

The terms "person associated with a public accounting firm" (or with a "registered public accounting firm" or "applicant") and "associated person of a public accounting firm" (or of a "registered public accounting firm" or "applicant") mean any individual proprietor, partner, shareholder, principal, accountant, or professional employee of a public accounting firm, or any independent contractor that, in connection with the preparation or issuance of any audit report—

(1) shares in the profits of, or receives compensation in any other form from, that firm; or

(2) participates as agent on behalf of such accounting firm in any activity of that firm;

provided, however, that these terms do not include a person engaged only in clerical or ministerial tasks or a person whom the public accounting firm reasonably believes is a person primarily associated with another registered public accounting firm.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(p)(ii) Play a Substantial Role in the Preparation or Furnishing of an Audit Report

The phrase "play a substantial role in the preparation or furnishing of an audit report" means—

(1) to perform material services that a public accounting firm uses or relies on in issuing all or part of its audit report with respect to any issuer, or

(2) to perform the majority of the audit procedures with respect to a subsidiary or component of any issuer the assets or revenues of which constitute 20% or more of the consolidated assets or revenues of such issuer necessary for the principal accountant to issue an audit report on the issuer.

Note 1: For purposes of paragraph (1) of this definition, the term "material services" means services, for which the engagement hours or fees constitute 20% or more of the total engagement hours or fees, respectively, provided by the principal accountant in connection with the issuance of all or part of its audit report with respect to any issuer. The term does not include non-audit services provided to non-audit clients.

Note 2: For purposes of paragraph (2) of this definition, the phrase "subsidiary or component" is meant to include any subsidiary, division, branch, office or other component of an issuer, regardless of its form of organization and/or control relationship with the issuer.

Note 3: For purposes of determining "20% or more of the consolidated assets or revenues" under paragraph (2) of this Rule, this determination should be made at the beginning of the issuer's fiscal year using prior year information and should be made only once during the issuer's fiscal year.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(p)(iii) Public Accounting Firm

The term "public accounting firm" means a proprietorship, partnership, incorporated association, corporation, limited liability company, limited liability partnership, or other legal entity that is engaged in the practice of public accounting or preparing or issuing audit reports.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(p)(iii) Party

The term "party" means the interested division, any person named as a respondent in an order instituting proceedings or notice of a hearing, any applicant named in the caption of any order, or any person seeking Board review of a decision.

[Effective pursuant to SEC Release No. 34-49704, File No. PCAOB-2003-07 (May 14, 2004)]

(p)(iv) Person

The term "person" means any natural person or any business, legal or governmental entity or association.

[Effective pursuant to SEC Release No. 34-49704, File No. PCAOB-2003-07 (May 14, 2004)]

(p)(vi) Professional Standards

The term "professional standards" means—

(A) accounting principles that are—

(i) established by the standard setting body described in section 19(b) of the Securities Act of 1933, as amended by the Act, or prescribed by the Commission under section 19(a) of the Securities Act of 1933 or section 13(b) of the Securities Exchange Act of 1934; and

(ii) relevant to audit reports for particular issuers, or dealt with in the quality control system of a particular registered public accounting firm; and

(B) auditing standards, standards for attestation engagements, quality control policies and procedures, ethical and competency standards, and independence standards (including rules implementing Title II of the Act) that the Board or the Commission determines—

(i) relate to the preparation or issuance of audit reports for issuers; and

(ii) are established or adopted by the Board under section 103(a) of the Act, or are promulgated as rules of the Commission.

[Effective pursuant to SEC Release No. 34-49787, File No. PCAOB-2003-08 (June 1, 2004)]

(r)(i) Registered Public Accounting Firm

The term "registered public accounting firm" means a public accounting firm registered with the Board.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(r)(ii) Rules or Rules of the Board

The terms "Rules" or "Rules of the Board" mean the bylaws and rules of the Board (as submitted to and approved, modified, or amended by the Commission in accordance with Section 107 of the Act) and those stated policies, practices, and interpretations of the Board that the Commission, by rule, may deem to be rules of the Board, as necessary or appropriate in the public interest or for the protection of investors.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(r)(iii) Revocation

The term "revocation" means a permanent disciplinary sanction terminating a firm's registration.

[Effective pursuant to SEC Release No. 34-49704, File No. PCAOB-2003-07 (May 14, 2004)]

(s)(i) Securities Act

The term "Securities Act" means the Securities Act of 1933, as amended.

[Effective pursuant to SEC Release No. 34-48278, File No. PCAOB-2003-02 (August 1, 2003)]

(s)(ii) Securities Laws

The term "securities laws" means the provisions of the law referred to in Section 3(a)(47) of the Exchange Act, as amended by the Act, and includes the rules, regulations, and orders issued by the Commission thereunder.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(s)(iii) State

The term "State" means any state of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other territory or possession of the United States.

[Effective pursuant to SEC Release No. 34-48180, File No. PCAOB-2003-03 (July 16, 2003)]

(s)(iii) Secretary

The term "Secretary" means the Secretary of the Board.

[Effective pursuant to SEC Release No. 34-49704, File No. PCAOB-2003-07 (May 14, 2004)]

(s)(iv) Suspension

The term "suspension" means a temporary disciplinary sanction, which lapses by its own terms, prohibiting—

(1) a registered public accounting firm from preparing or issuing, or participating in the preparation or issuance of, any audit report with respect to any issuer; or

(2) a person from being associated with a registered public accounting firm.

[Effective pursuant to SEC Release No. 34-49704,
File No. PCAOB-2003-07 (May 14, 2004)]

(t)(i) Tax Services

The term "tax services" means professional services rendered for tax compliance, tax advice, and tax planning.

[Effective pursuant to SEC Release No. 34-48180,
File No. PCAOB-2003-03 (July 16, 2003)]

SECTION 3.

PROFESSIONAL STANDARDS

Part 1—General Requirements

Rule 3100. Compliance With Auditing and Related Professional Practice Standards.

A registered public accounting firm and its associated persons shall comply with all applicable auditing and related professional practice standards.

[Effective pursuant to SEC Release No. 34-48730;
File No. PCAOB-2003-05; October 31, 2003]

Rule 3101. Certain Terms Used in Auditing and Related Professional Practice Standards.

(a) The Board's auditing and related professional practice standards use certain terms set forth in this rule to describe the degree of responsibility that the standards impose on auditors.

(1) **Unconditional Responsibility:** The words "must," "shall," and "is required" indicate unconditional responsibilities. The auditor must fulfill responsibilities of this type in all cases in which the circumstances exist to which the requirement applies. Failure to discharge an unconditional responsibility is a violation of the relevant standard and Rule 3100.

(2) **Presumptively Mandatory Responsibility:** The word "should" indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type specified in the Board's standards unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard. Failure to discharge a presumptively mandatory responsibility is a violation of the relevant standard and Rule 3100 unless the auditor demonstrates that, in the circumstances, compliance with the specified responsibility was not necessary to achieve the objectives of the standard.

Note: In the rare circumstances in which the auditor believes the objectives of the standard can be met by alternative means, the auditor, as part of documenting the planning and performance of the work, must document the information that demonstrates that the objectives were achieved.

(3) **Responsibility To Consider:** The words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a responsibility to consider. Matters described in this fashion require the auditor's attention and understanding. How and whether the auditor implements these matters in the audit will depend on

the exercise of professional judgment in the circumstances consistent with the objectives of the standard.

Note: If a Board standard provides that the auditor "should consider" an action or procedure, consideration of the action or procedure is presumptively mandatory, while the action or procedure is not.

(b) The terminology in paragraph (a) of this rule applies to the responsibilities imposed by the auditing and related professional practice standards, including the interim standards adopted in Rules 3200T, 3300T, 3400T, 3500T, and 3600T.

(c) The documentation requirement in paragraph (a)(2) is effective for audits of financial statements or other engagements with respect to fiscal years ending on or after November 15, 2004.

[Effective pursuant to SEC Release No. 34-50331; File No. PCAOB-2004-06, September 8, 2004]

Rule 3200T. Interim Auditing Standards.

In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement of Auditing Standards No. 95, as in existence on April 16, 2003 (Codification of Statements on Auditing Standards, AU § 150 (AICPA 2002)), to the extent not superseded or amended by the Board.

Note: Under Section 102(a) of the Act, public accounting firms are not required to be registered with the Board until 180 days after the date of the determination of the Commission under section 101(d) that the Board has the capacity to carry out the requirements of Title I of the Act (the "mandatory registration date"). The Board intends that, during the period preceding the mandatory registration date, the Interim Auditing Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

[Effective pursuant to SEC Release No. 34-49624; File No. PCAOB-2003-11; April 28, 2004 and SEC Release Nos 33-8233 & 3447746; April 25, 2003]

Rule 3300T. Interim Attestation Standards.

In connection with an engagement (i) described in the AICPA's Auditing Standards Board's Statement on Standards for Attestation Engagements No. 10 (Codification of Statements on Auditing Standards, AT § 101.01 (AICPA 2002)) and (ii) related to the preparation or issuance of audit reports for issuers, a registered public accounting firm, and its associated persons, shall comply with the AICPA Auditing Standards Board's Statements on Standards for Attestation Engagements, and related interpretations and Statements of Position, as in existence on April 16, 2003, to the extent not superseded or amended by the Board.

Note: The Board intends that, during the period preceding the mandatory registration date, the Interim Attestation Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

[Effective pursuant to SEC Release No. 34-49624; File No. PCAOB-2003-11; April 28, 2004 and SEC Release Nos 33-8233 & 3447746; April 25, 2003]

Rule 3400T. Interim Quality Control Standards.

A registered public accounting firm, and its associated persons, shall comply with quality control standards, as described in—

(a) the AICPA's Auditing Standards Board's Statements on Quality Control Standards, as in existence on April 16, 2003 (AICPA Professional Standards, QC §§ 20–40 (AICPA 2002)), to the extent not superseded or amended by the Board; and

(b) the AICPA SEC Practice Section's Requirements of Membership (d), (f)(first sentence), (l), (m), (n)(1) and (o), as in existence on April 16, 2003 (AICPA SEC Practice Section Manual § 1000.08(d), (f), (j), (m), (n)(1) and (o)), to the extent not superseded or amended by the Board.

Note: The second sentence of requirement (f) of the AICPA SEC Practice Section's Requirements of Membership provided for the AICPA's peer review committee to "authorize alternative procedures" when the requirement for a concurring review could not be met because of the size of the firm. This provision is not adopted as part of the Board's Interim Quality Control Standards. After the effective date of the Interim Quality Control Standards, requests for authorization of alternative procedures to a concurring review may, however, be directed to the Board.

Note: The Board intends that, during the period preceding the mandatory registration date, the Interim Quality Control Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

[Effective pursuant to SEC Release No. 34-49624; File No. PCAOB-2003-11; April 28, 2004 and SEC Release Nos 33-8233 & 3447746; April 25, 2003]

Part 5—Ethics

Rule 3500T. Interim Ethics Standards.

In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with ethics standards, as described in the AICPA's Code of Professional Conduct Rule 102, and interpretations and rulings thereunder, as in existence on April 16, 2003 (AICPA Professional Standards, ET §§ 102 and 191 (AICPA 2002)), to the extent not superseded or amended by the Board.

Note: The Board intends that, during the period preceding the mandatory registration date, the Interim Ethics Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

[Effective pursuant to SEC Release No. 34-49624; File No. PCAOB-2003-11;

April 28, 2004 and SEC Release Nos 33-8233 & 3447746;

April 25, 2003]

Rule 3501. Definitions of Terms Employed in Section 3, Part 5 of the Rules.

When used in Section 3, Part 5 of the Rules, unless the context otherwise requires:

(a)(i) Affiliate of the Accounting Firm.

The term "affiliate of the accounting firm" (or "affiliate of the registered public accounting firm" or "affiliate of the firm") includes the accounting firm's parents; subsidiaries; pension, retirement, investment or similar plans; and any associated entities of the firm, as that term is used in Rule 2-01 of the Commission's Regulation SX, 17 C.F.R. § 210.2-01(f)(2).

(a)(ii) Affiliate of the Audit Client.

The term "affiliate of the audit client" means—

(1) An entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client's parents and subsidiaries;

(2) An entity over which the audit client has significant influence, unless the entity is not material to the audit client;

(3) An entity that has significant influence over the audit client, unless the audit client is not material to the entity; and

(4) Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex.

(a)(iii) Audit and Professional Engagement Period.

The term "audit and professional engagement period" includes both—

(1) The period covered by any financial statements being audited or reviewed (the "audit period"); and

(2) The period of the engagement to audit or review the audit client's financial statements or to prepare a report filed with the Commission (the "professional engagement period")—

(A) The professional engagement period begins when the registered public accounting firm either signs an initial engagement letter (or other agreement to review or audit a client's financial statements) or begins audit, review, or attest procedures, whichever is earlier; and

(B) The professional engagement period ends when the audit client or the registered public accounting firm notifies the Commission that the client is no longer that firm's audit client.

(3) For audits of the financial statements of foreign private issuers, the "audit and professional engagement period" does not include periods ended prior to the first day of the last fiscal year before the foreign private issuer first filed, or was required to file, a registration statement or report with the Commission, provided there has been full compliance with home country independence standards in all prior periods covered by any registration statement or report filed with the Commission.

(a)(iv) Audit Client.

The term "audit client" means the entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client.

(c)(i) Confidential Transaction.

The term "confidential transaction" means—

(1) In general. A confidential transaction is a transaction that is offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a fee.

(2) Conditions of confidentiality. A transaction is considered to be offered to a taxpayer under conditions of confidentiality if the advisor who is paid the fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies. A transaction is treated as confidential even if the conditions of confidentiality are not legally binding on the taxpayer. A claim that a transaction is proprietary or exclusive is not treated as a limitation on disclosure if the advisor confirms to the taxpayer that there is no limitation on disclosure of the tax treatment or tax structure of the transaction.

(3) Determination of fee. For purposes of this definition, a fee includes all fees for a tax strategy or for services for advice (whether or not tax advice) or for the implementation of a transaction. These fees include consideration in whatever form paid, whether in cash or in kind, for services to analyze the transaction (whether or not related to the tax consequences of the transaction), for services to implement the transaction, for services to document the transaction, and for services to prepare tax returns to the extent that the fees exceed the fees customary for return preparation. For purposes of this definition, a taxpayer also is treated as paying fees to an advisor if the taxpayer knows or should know that the amount it pays will be paid indirectly to the advisor, such as through a

referral fee or fee-sharing arrangement. A fee does not include amounts paid to a person, including an advisor, in that person's capacity as a party to the transaction. For example, a fee does not include reasonable charges for the use of capital or the sale or use of property.

(4) Related parties. For purposes of this definition, persons who bear a relationship to each other as described in section 267(b) or 707(b) of the Internal Revenue Code will be treated as the same person.

(c)(ii) Contingent Fee.

The term "contingent fee" means—

(1) Except as stated in paragraph (2) below, any fee established for the sale of a product or the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service.

(2) Solely for the purposes of this definition, a fee is not a "contingent fee" if the amount is fixed by courts or other public authorities and not dependent on a finding or result.

(f)(i) Financial Reporting Oversight Role.

The term "financial reporting oversight role" means a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

(i)(i) Immediate Family Member.

The term "immediate family member" means a person's spouse, spousal equivalent, and dependents.

(i)(ii) Investment Company Complex.

(1) The term "investment company complex" includes—

(i) An investment company and its investment adviser or sponsor;

(ii) Any entity controlled by or controlling an investment adviser or sponsor in paragraph (i) of this definition, or any entity under common control with an investment adviser or sponsor in paragraph (i) of this definition if the entity—

(A) Is an investment adviser or sponsor; or

(B) Is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment adviser, or sponsor; and

(iii) Any investment company or entity that would be an investment company but for the exclusions provided by section 3(c) of the Investment Company Act of 1940 (15 U.S.C. § 80a-3(c)) that has an investment adviser or sponsor

included in this definition by either paragraph (i) or (ii) of this definition.

(2) An investment adviser, for purposes of this definition, does not include a sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser.

(3) A sponsor, for purposes of this definition, is an entity that establishes a unit investment trust.

[Effective pursuant to SEC Release No. 34-53677; File No. PCAOB-2006-01; April 19, 2006]

Rule 3502. Responsibility Not to Knowingly or Recklessly Contribute to Violations.

A person associated with a registered public accounting firm shall not take or omit to take an action knowing, or recklessly not knowing, that the act or omission would directly and substantially contribute to a violation by that registered public accounting firm of the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards.

[Effective pursuant to SEC Release No. 34-53677; File No. PCAOB-2006-01; April 19, 2006; As amended, effective April 29, 2006, by PCAOB Release No. 2005-020.]

Subpart 1—Independence

Rule 3520. Auditor Independence.

A registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period.

Note 1: Under Rule 3520, a registered public accounting firm or associated person's independence obligation with respect to an audit client that is an issuer encompasses not only an obligation to satisfy the independence criteria set out in the rules and standards of the PCAOB, but also an obligation to satisfy all other independence criteria applicable to the engagement, including the independence criteria set out in the rules and regulations of the Commission under the federal securities laws.

Note 2: Rule 3520 applies only to those associated persons of a registered public accounting firm required to be independent of the firm's audit client by standards, rules or regulations of the Commission or other applicable independence criteria.

[Effective pursuant to SEC Release No. 34-53677; File No. PCAOB-2006-01; April 19, 2006]

Rule 3521. Contingent Fees.

A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any service or product to the audit client for a contingent fee or a commission, or receives from the audit client, directly or indirectly, a contingent fee or commission.

[Effective pursuant to SEC Release No. 34-53677;
File No. PCAOB-2006-01; April 19, 2006]

Rule 3522. Tax Transactions.

A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any non-audit service to the audit client related to marketing, planning, or opining in favor of the tax treatment of, a transaction—

(a) **Confidential Transactions**—that is a confidential transaction; or

(b) **Aggressive Tax Position Transactions**—that was initially recommended, directly or indirectly, by the registered public accounting firm and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws.

Note 1: With respect to transactions subject to the United States tax laws, paragraph (b) of this rule includes, but is not limited to, any transaction that is a listed transaction within the meaning of 26 C.F.R. §1.6011(b)(2).

Note 2: A registered public accounting firm indirectly recommends a transaction when an affiliate of the firm or another tax advisor, with which the firm has a formal agreement or other arrangement related to the promotion of such transactions, recommends engaging in the transaction.

[Effective pursuant to SEC Release No. 34-53677;
File No. PCAOB-2006-01; April 19, 2006;
As amended, effective April 29, 2006, by PCAOB Release No. 2005-020.]

Rule 3523. Tax Services for Persons in Financial Reporting Oversight Roles.

A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the professional engagement period provides any tax service to a person in a financial reporting oversight role at the audit client, or an immediate family member of such person, unless—

(a) the person is in a financial reporting oversight role at the audit client only because he or she serves as a member of the board of directors or similar management or governing body of the audit client;

(b) the person is in a financial reporting oversight role at the audit client only because of the person's relationship to an affiliate of the entity being audited—

(1) whose financial statements are not material to the consolidated financial statements of the entity being audited; or

(2) whose financial statements are audited by an auditor other than the firm or an associated person of the firm; or

(c) the person was not in a financial reporting oversight role at the audit client before a hiring, promotion, or other change in employment event and the tax services are—

(1) provided pursuant to an engagement in process before the hiring, promotion, or other change in employment event; and

(2) completed on or before 180 days after the hiring or promotion event.

Note: In an engagement for an audit client whose financial statements for the first time will be required to be audited pursuant to the standards of the PCAOB, the provision of tax services to a person covered by Rule 3523 before the earlier of the date that the firm: (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB, or (2) began procedures to do so, does not impair a registered public accounting firm's independence under Rule 3523.

[Effective pursuant to SEC Release No. 34-53677; File No. PCAOB-2006-01; April 19, 2006; As amended, effective April 22, 2008, by PCAOB Release No. 2008-003]

Rule 3524. Audit Committee Pre-approval of Certain Tax Services.

In connection with seeking audit committee pre-approval to perform for an audit client any permissible tax service, a registered public accounting firm shall—

(a) describe, in writing, to the audit committee of the issuer—

(1) the scope of the service, the fee structure for the engagement, and any side letter or other amendment to the engagement letter, or any other agreement (whether oral, written, or otherwise) between the firm and the audit client, relating to the service; and

(2) any compensation arrangement or other agreement, such as a referral agreement, a referral fee or fee-sharing arrangement, between the registered public accounting firm (or an affiliate of the firm) and any person (other than the audit client) with respect to the promoting, marketing, or recommending of a transaction covered by the service;

(b) discuss with the audit committee of the issuer the potential effects of the services on the independence of the firm; and

(c) document the substance of its discussion with the audit committee of the issuer.

[Effective pursuant to SEC Release No. 34-53677; File No. PCAOB-2006-01; April 19, 2006]

Rule 3525. Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting.

In connection with seeking audit committee pre-approval to perform for an audit client any permissible non-audit service related to internal control over financial reporting, a registered public accounting firm shall—

(a) describe, in writing, to the audit committee of the issuer the scope of the service;

(b) discuss with the audit committee of the issuer the potential effects of the service on the independence of the firm; and

Note: Independence requirements provide that an auditor is not independent of his or her audit client if the auditor is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. Several principles guide the application of this general standard, including whether the auditor assumes a management role or audits his or her own work. Therefore, an auditor would not be independent if, for example, management had delegated its responsibility for internal control over financial reporting to the auditor or if the auditor had designed or implemented the audit client's internal control over financial reporting.

(c) document the substance of its discussion with the audit committee of the issuer.

[Effective pursuant to SEC Release No. 34-56152; File No. PCAOB-2007-02; July 27, 2007]

Rule 3526. Communication with Audit Committees Concerning Independence.

A registered public accounting firm must—

(a) prior to accepting an initial engagement pursuant to the standards of the PCAOB—

(1) describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence;

(2) discuss with the audit committee of the issuer the potential effects of the relationships described in subsection (a)(1) on the independence of the registered public accounting firm, should it be appointed the issuer's auditor; and

(3) document the substance of its discussion with the audit committee of the issuer.

(b) at least annually with respect to each of its issuer audit clients—

(1) describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the audit client or

persons in financial reporting oversight roles at the audit client that, as of the date of the communication, may reasonably be thought to bear on independence;

(2) discuss with the audit committee of the issuer the potential effects of the relationships described in subsection (b)(1) on the independence of the registered public accounting firm;

(3) affirm to the audit committee of the issuer, in writing, that, as of the date of the communication, the registered public accounting firm is independent in compliance with Rule 3520; and

(4) document the substance of its discussion with the audit committee of the issuer.

[Effective pursuant to SEC Release No. 34-58415, File No. PCAOB-2008-03; August 22, 2008]

Rule 3600T. Interim Independence Standards.

In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with independence standards—

(a) as described in the AICPA's Code of Professional Conduct Rule 101, and interpretations and rulings thereunder, as in existence on April 16, 2003 (AICPA Professional Standards, ET §§ 101 and 191 (AICPA 2002)), to the extent not superseded or amended by the Board; and

(b) Standards Nos. 1, 2, and 3, and Interpretations 99-1, 00-1, and 00-2, of the Independence Standards Board, to the extent not superseded or amended by the Board.

Note: The Board's Interim Independence Standards do not supercede the Commission's auditor independence rules. See Rule 2-01 of Reg. S-X, 17 C.F.R. 240.2-01. Therefore, to the extent that a provision of the Commission's rule is more restrictive—or less restrictive—than the Board's Interim Independence Standards, a registered public accounting firm must comply with the more restrictive rule.

Note: The Board intends that, during the period preceding the mandatory registration date, the Interim Independence Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

[Effective pursuant to SEC Release No. 34-49624; File No. PCAOB-2003-11; April 28, 2004 and SEC Release Nos 33-8233 & 3447746; April 25, 2003]

Part 7—Establishment of Professional Standards

Rule 3700. Advisory Groups.

(a) Formation.

To assist it in carrying out its responsibility to establish auditing and related professional practice standards, the Board will convene one or more advisory groups, in accordance with Section 103(a)(4) of the Act.

(b) Composition.

Advisory groups, in combination or as sub-groups designated by the Board within one advisory group, will contain individuals with expertise in one or more of the following areas—

(1) accounting;
(2) auditing;
(3) corporate finance;
(4) corporate governance;
(5) investing in public companies; and
(6) other areas that the Board deems to be relevant to one or more auditing or related professional practice standards

(c) Selection of Members of Advisory Groups.

Members of advisory groups will be selected by the Board, in its sole discretion, based upon nominations, including self-nominations, received from any person or organization.

Note: The Board will announce, from time to time, periods during which it will receive nominations to an advisory group. During those periods, nominations may be submitted by any person or organization, including, but not limited to, any investor, any accounting firm, any issuer, and any institution of higher learning.

(d) Personal Membership.

Membership in an advisory group will be personal to the individuals selected to serve on the advisory group. A member's functions and responsibilities, including attendance at meetings, may not be delegated to others.

(e) Ethical Duties of Advisory Group Members.

Members of an advisory group shall comply with EC3, EC8(a), EC9, and, with respect to any private publication or public statement about the Board or any advisory group or any of the activities of the Board or any advisory group, EC10 of the Board's Ethics Code.

(f) Ad Hoc Task Forces.

The Board may, in its discretion, establish ad hoc task forces. The membership of such task forces may include, but is not limited to, advisory group members. To the extent not otherwise required, members of ad hoc task forces shall comply with paragraph (e) of this Rule.

[Effective pursuant to SEC Release No. 34-48730;

File No. PCAOB-2003-05; October 31, 2003]

SELECT RULES OF THE BOARD TOPICAL INDEX

References are to Rules of the Board section numbers.

D

E

G

I

Select PCAOB Releases

Notice: This section is not a complete presentation of the releases issued by the PCAOB. See the PCAOB website (www.pcaob.org) to view the excluded releases.

Select PCAOB Releases

Introduction

The Sarbanes-Oxley Act (act) authorizes the Public Company Accounting Oversight Board (PCAOB) to establish auditing and related attestation, quality control, ethics, and independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports for entities subject to the act or the rules of the Securities and Exchange Commission (SEC). Accordingly, public accounting firms registered with the PCAOB are required to adhere to all PCAOB standards in the audits of issuers, as defined by the act, and other entities when prescribed by the rules of the SEC.

TABLE OF CONTENTS

PCAOB Release No. 2003-006

Establishment of Interim Professional Auditing Standards

PCAOB Release No. 2003-006
April 18, 2003

Summary:

The Public Company Accounting Oversight Board ("Board" or "PCAOB") has established interim standards of auditing, attestation, quality control, ethics, and independence ("Interim Professional Auditing Standards"). Section 103(a) of the Sarbanes-Oxley Act of 2002 ("Act") provides that the Board shall, by rule, establish auditing and related attestation, quality control, and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports. Section 103(b) authorizes the Board to adopt rules relating to auditor independence. The Board's Interim Professional Auditing Standards were promulgated by various other bodies and pre-date the determination of the Securities and Exchange Commission ("Commission"), under Section 101(d), that the Board is capable of carrying out its responsibilities under the Act. Unlike other Rules of the Board, under Section 103(a)(3)(B) of the Act, the Board's Interim Professional Auditing Standards "shall be separately approved by the Commission at the time of the determination, without regard to the procedures required by Section 107" of the Act regarding rulemaking.

This release describes the standards that the Board has adopted as Interim Professional Auditing Standards on an initial, transitional basis in order to assure continuity and certainty in the standards that govern audits of public companies. They will remain in effect while the Board conducts a review of standards applicable to registered public accounting firms, as discussed in PCAOB Release No. 2003-005. Based on this review, the Board may modify, repeal, replace or adopt permanently the Interim Professional Auditing Standards, or any part thereof, by rulemaking according to the Board's procedures for the establishment of professional auditing standards and subject to Commission approval.

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The Board has adopted Interim Professional Auditing Standards to govern the conduct of audits of public companies (i.e., "issuers" as defined in the Act). The Act provides that "[p]re-existing standards of designated professional groups of accountants may be adopted during the Board's transitional period,"[1] i.e., before the Commission's determination, under Section 101(d), that the Board is "organized and has the capacity to carry out the requirements of Title I" of the Act. Specifically, Section 103(a)(3)(B) and 103(a)(3)(A)(i) of the Act provide for the Board to adopt, as initial or transitional standards, "any portion of any

[1] See S. Rep. No. 107-205, at 8 (2002).

statement of auditing standards or other professional standards" that satisfy the requirements of Section 103(a)(1) of the Act. These interim standards are to be "separately approved by the Commission at the time of the determination, without regard to the procedures required by Section 107" of the Act regarding rulemaking, which will govern the Board's permanent standards.[2]

Despite the need to adopt these existing standards on an initial, transitional basis in order to assure continuity and certainty in the standards that govern audits of public companies, the Board has not determined whether it would be appropriate to include any of the Interim Professional Auditing Standards as permanent Board standards. In order to make that determination, the Board will establish a schedule and procedure for the review of all Interim Professional Auditing Standards.[3] The objective of that review will be to determine, on a standard-by-standard basis, whether the Interim Professional Auditing Standards should become permanent standards of the Board, should be repealed, or should be modified. As the review of each interim standard is completed, the Board will adopt that standard as a permanent Professional Auditing Standard, with or without modifications, will repeal the standard, or will take any other appropriate action regarding the standard.

The Interim Professional Auditing Standards consist of five rules (Rules 3200T, 3300T, 3400T, 3500T, and 3600T). Appendices 1 and 2 to this release contain, respectively, the text of these rules and a section-by-section analysis of the rules. Section A of this release provides an overview of the Interim Professional Auditing Standards and of the Board's reasons for adopting these standards. Section B of this release describes the effective date of the Interim Professional Auditing Standards and the procedure for Commission approval of these standards..., other than as provided in section 103(a)(3)(B) with respect to initial or transitional standards."

A. Overview of the Interim Professional Auditing Standards

1. Interim Auditing Standards

Auditors of public companies that issue securities are required to provide audit reports that "state whether the audit was made in accordance with generally accepted auditing standards" ("GAAS").[4] The Commission's Division of Corporation Finance will not accept an audit report on the financial statements of an issuer unless the report states that the audit to which it relates was conducted in accordance with GAAS in the United States.[5]

Before the enactment of the Act, U.S. GAAS were established by the American Institute of Certified Public Accountants ("AICPA"). General standards on auditing, as well as standards relating to audit field work and audit reports, were approved and adopted by the membership of the AICPA, and amended by the AICPA's Auditing Standards Board ("ASB"). In addition, the ASB has

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[2] Section 103(a)(3)(B) of the Act. Section 107(b)(2) of the Act provides that "[n]o rule of the Board shall become effective without prior approval of the Commission.

[3] See PCAOB Release No. 2003-005 (April 18, 2003).

[4] See Regulation S-X, § 2-02, 17 C.F.R. § 210.2-02.

[5] "All financial statements filed with the SEC are required to be audited in accordance with US GAAS, with an explicit statement of that fact in the auditor's report." See Division of Corporation Finance Current Accounting and Disclosure Issues (August 31, 2001), http://www.sec.gov/divisions/corpfin/acctdisc.htm.

developed and issued 101 Statements of Auditing Standards ("SAS") through a process that has included deliberations in public meetings, public exposure of draft statements, and adoption of statements approved by the ASB.[6] GAAS also require an auditor to "be aware of and consider" certain AICPA interpretive publications, such as auditing Interpretations of the SASs, auditing guidance included in AICPA Audit and Accounting Guides, and AICPA auditing Statements of Position.[7]

Subject to the Commission's oversight authority, the Act gives the Board the exclusive, statutory power to establish and amend Professional Auditing Standards to be used by registered public accounting firms in the preparation and issuance of audit reports.[8] The Board's Professional Auditing Standards supercede standards established by professional organizations, with respect to the preparation or issuance of audit reports on the financial statements of issuers. In Release No. 2003-005, the Board announced its intention to establish Professional Auditing Standards through an open process in which the accounting profession, the preparers of financial statements, the investor community, and others will have the opportunity to participate. The Board also announced in that release a plan to review existing GAAS and, when appropriate, change or establish new GAAS.

In order to assure continuity and certainty in the standards that govern audits of public companies during the Board's review, the Board has determined that GAAS proposed and promulgated by the AICPA and the ASB, as they existed on April 16, 2003, should be adopted as Interim Auditing Standards, pursuant to Section 103(a)(3)(B). Accordingly, the Board has adopted Rule 3200T to require that registered public accounting firms comply with its Interim Auditing Standards in the performance of audits, or interim reviews,[9] of the financial statements of issuers. The Board intends that these GAAS continue to have the same authority they have currently unless and until the Board supercedes them.

2. Interim Attestation Standards

Section 103(a)(1) authorizes the Board to establish "auditing and related attestation standards."[10] Consistent with the Interim Auditing Standards, the

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[6] See SAS No. 95, *Codification of Statements on Auditing Standards* ("Codification"), AU § 150.03 (AICPA 2002).

[7] In addition, SAS No. 95 also refers to other auditing publications, such as articles in the Journal of Accountancy and other professional journals, including publications by state CPA societies, textbooks, and guidebooks, that have contributed to the development of GAAS. Before applying the guidance in an "other auditing publication," an auditor "should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate." SAS No. 95, Codification at AU § 150.08.

[8] Section 3(c)(2) of the Act provides that "[n]othing in this Act or the rules of the Board shall be construed to impair or limit . . . the authority of the Commission to set standards for accounting or auditing practices or auditor independence, derived from other provisions of the securities laws or the rules or regulations thereunder, for purposes of the preparation and issuance of any audit report, or otherwise under applicable law."

[9] Interim reviews of financial information are integrally related to audits. See generally SAS No. 100. For example, SAS No. 100 makes clear that the general standards on auditing discussed in SAS No. 95 "are applicable to a review of interim financial information." See id. at ¶ 1; see also id. at ¶¶ 12-13 (requiring new auditor conducting initial review of interim financial information to perform procedures, including making inquiries and reviewing the work papers of predecessor auditor and obtaining knowledge of entity's internal controls).

[10] Section 2(a)(10) of the Act also defines Professional Standards to include "standards for attestation engagements . . . that the Board or the Commission determines . . . relate to the preparation or issuance of audit reports for issuers."

Board's Rule 3300T designates the Statements on Standards for Attestation Engagements ("SSAE") and related Interpretations and Statements of Position adopted by the ASB, as they existed on April 16, 2003, as the Board's Interim Attestation Standards. Accordingly, registered public accounting firms must comply with those SSAEs that are related to the preparation or issuance of an audit report on the financial statements of an issuer.[11]

3. Interim Quality Control Standards

Section 103(a)(1) authorizes the Board to establish quality control standards for registered public accounting firms. Until enactment of the Act, the ASB's Statements on Quality Control Standards ("SQCS") were the primary source of such standards.[12] In addition, public accounting firms that are members of the AICPA's SEC Practice Section have committed to satisfying a number of other quality control-related requirements. Consistent with the Interim Auditing Standards and the Interim Attestation Standards, the Board's Rule 3400T designates the Statements on Quality Control Standards adopted by the ASB, as they existed on April 16, 2003, as the Board's Interim Quality Control Standards.

Rule 3400T also designates certain AICPA SEC Practice Section membership requirements as additional Interim Quality Control Standards.[13] It should be noted that the Board is not adopting as interim standards the entirety of the AICPA SEC Practice Section's membership requirements.[14] Further, because the Board intends the Interim Quality Control Standards to preserve existing standards as they apply currently, consistent with Section 103(a)(3) of the Act, those Interim Quality Control Standards adapted from the AICPA SEC Practice Section requirements apply only to those firms that are members of the AICPA SEC Practice Section.[15] The requirements incorporated in Rule 3400T, which are described in more detail in Appendix 2, related to the following matters—

- Continuing professional education of audit firm personnel;
- Concurring partner review of the audit report and the financial statements of Commission registrants;[16]

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[11] Rule 3300T.

[12] See SAS 25, Codification at AU § 161 (requiring accounting firms to have quality controls for their audit practices). The ASB's standards define quality control as "a process to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality." See System of Quality Control for a CPA Firm's Accounting and Auditing Practice, AICPA Professional Standards ("Professional Standards"), QC § 20.03 (AICPA 2002). The ASB's standards further set forth five broad elements of appropriate quality control in a public accounting firm, which relate to maintaining independence, integrity, and objectivity; managing personnel; establishing guidelines for accepting and continuing clients; performing engagements; and monitoring the existing quality control policies and procedures. Professional Standards at QC § 20.07.

[13] AICPA SEC Practice Section Reference Manual, § 1000.08(d), (f), (l), (m), (n)(1) and (o).

[14] For example, the Board is not adopting those SECPS membership requirements that require each member of the firm to be a member of the AICPA or that require member firms to submit to peer reviews, to report information to the SECPS or to the AICPA's quality control inquiry committee, or to pay dues to the SECPS. See AICPA SEC Practice Section Reference Manual, § 1000.08(a), (c), (g), (j), (k) and (p). Nor is the Board adopting those SECPS membership requirements that have been superceded by statute or by Commission or Board rule.

[15] In the future the Board may, by rulemaking and pursuant to its standards-setting procedures, extend the AICPA SEC Practice Section requirements to other registered public accounting firms.

[16] SECPS membership requirement (f) sets forth the Practice Section's concurring review requirements, which the Board has adopted as part of its Interim Quality Control Standards. See AICPA SEC Practice Section Reference Manual, § 1000.08(f). Requirement (f) also permitted the AICPA "peer review committee [to] authorize alternative procedures where this requirement cannot be met because

(continued)

- Communication by written statement to all professional personnel of firm policies and procedures on the recommendation and approval of accounting principles, present and potential client relationships, and the types of services provided;
- Notification of the Commission of resignations and dismissals from audit engagements for Commission registrants;
- Audit firm obligations with respect to the policies and procedures of correspondent firms and of other members of international firms or international associations of firms; and
- Policies and procedures to comply with applicable independence requirements.

4. Interim Ethics Standards

Section 103(a)(1) authorizes the Board to establish ethics standards.[17] The Board's Rule 3500T designates the provisions of the AICPA's Code of Professional Conduct on integrity and objectivity, as Interim Ethics Standards.[18] Accordingly, registered public accounting firms must comply with the AICPA's Code of Professional Conduct Rule 102, and interpretations and rulings thereunder, as in existence as of the date of this release.[19] Consistent with the other interim standards adopted by the Board, these ethical standards continue to have the same authority they have currently unless and until the Board supercedes them.

5. Interim Independence Standards

Section 103(b) of the Act authorizes the Board to "establish such rules as may be necessary or appropriate in the public interest or for the protection of investors, to implement, or as authorized under, title II of this Act."[20] The Board has adopted Interim Independence Standards, based on the provisions of the AICPA's Code of Professional Conduct regarding independence and existing standards and interpretations of the Independence Standards Board. Rule 3600T requires registered public accounting firms to comply with these independence standards in connection with the audit of any Commission registrant.

On January 28, 2003, the Commission adopted final rules to strengthen requirements regarding auditor independence and enhance disclosure regarding fees paid to auditors and otherwise to strengthen the Commission's existing

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(footnote continued)

of the size of the member firm." The Board has not adopted this part—the second sentence—of SECPS membership requirement (f). Under Section 103(a)(3)(A)(i), the Board "may adopt as its rules . . any portion of any statement of auditing standards or other professional standards that the Board determines" satisfy the Act's requirements. The Board does, however, intend to permit requests for similar relief to be sought from the Board.

[17] Section 2(a)(10)(B) of the Act also defines Professional Standards to include "ethical and competency standards . . . that the Board or the Commission determines . . . relate to the preparation or issuance of audit reports for issuers."

[18] Professional Standards at ET §§ 102 and 191.

[19] Rule 3500T.

[20] Title II of the Act addresses auditor independence. In addition, Section 2(a)(10) of the Act defines "Professional Standards" to include "independence standards (including rules implementing title II) that the Board or the Commission determines . . . relate to the preparation or issuance of audit reports for issuers."

auditor independence rules.[21] These rules were designed to implement provisions of the Act. All registered public accounting firms are required to comply with Commission rules, and the Board's Interim Independence Standards do not supplant the Commission's independence rules. To the extent that the Commission's rules are more restrictive—or less restrictive—than the Board's Interim Independence Standards, registered public accounting firms must comply with the more restrictive requirements. The note to Rule 3600T clarifies this point.

B. Effective Date for the Interim Professional Auditing Standards and Procedure for Commission Approval

Under Section 103(a)(3)(B) of the Act, the Board's Interim Professional Auditing Standards "shall be separately approved by the Commission at the time of [the] determination" of the Commission under Section 101(d) of the Act that the Board has the capacity to carry out the requirements of Title I of the Act. This determination is expected to be made no later than April 26, 2003.[22] The Interim Professional Auditing Standards shall be effective as of the date of the Commission's approval of them, which, accordingly, is expected to be no later than April 26, 2003.

* * * * * *

On the 16th day of April, in the year 2003, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ISSUED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Acting Secretary
April 16, 2003

APPENDICES—

1. Rules Relating to Interim Professional Auditing Standards
2. Section-by-Section Analysis of Rules Relating to Interim Professional Auditing Standards

[21] See SEC, Strengthening the Commission's Requirements Regarding Auditor Independence, Securities Act Release No. 33-8183, 68 Fed. Reg. 6,006 (Jan. 28, 2003), as amended by Securities Act Release No. 33-8183A, 68 Fed. Reg. 15,354 (March 26, 2003).

[22] Section 101(d) of the Act requires the Board to take such actions as are necessary or appropriate to enable the Commission to make this determination no later than 270 days after the enactment of the Act, i.e., no later than April 26, 2003.

Appendix 1

Rules Relating to Interim Professional Auditing Standards

RULES OF THE BOARD

SECTION 7. PROFESSIONAL STANDARDS

RULE 3200T. Interim Auditing Standards.

In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement of Auditing Standards No. 95, as in existence on April 16, 2003 (Codification of Statements on Auditing Standards, AU § 150 (AICPA 2002)).

> Note: Under Section 102(a) of the Act, public accounting firms are not required to be registered with the Board until 180 days after the date of the determination of the Commission under section 101(d) that the Board has the capacity to carry out the requirements of Title I of the Act (the "mandatory registration date"). The Board intends that, during the period preceding the mandatory registration date, the Interim Auditing Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

[PCAOB Release No. 2003-026, *Technical Amendments to Interim Standards Rules*, amends Rule 3200T. See Release No. 2003-026 for language of the amendment.]

RULE 3300T. Interim Attestation Standards.

In connection with an engagement (i) described in the AICPA's Auditing Standards Board's Statement on Standards for Attestation Engagements No. 10 (Codification of Statements on Auditing Standards, AT § 101.01 (AICPA 2002)) and (ii) related to the preparation or issuance of audit reports for issuers, a registered public accounting firm, and its associated persons, shall comply with the AICPA Auditing Standards Board's Statements on Standards for Attestation Engagements, and related interpretations and Statements of Position, as in existence on April 16, 2003.

> Note: The Board intends that, during the period preceding the mandatory registration date, the Interim Attestation Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

[PCAOB Release No. 2003-026, *Technical Amendments to Interim Standards Rules*, amends Rule 3300T. See Release No. 2003-026 for language of the amendment.]

RULE 3400T. Interim Quality Control Standards.

A registered public accounting firm, and its associated persons, shall comply with quality control standards, as described in—

(*a*) the AICPA's Auditing Standards Board's Statements on Quality Control Standards, as in existence on April 16, 2003 (AICPA Professional Standards, QC §§ 20–40 (AICPA 2002)); and

(*b*) the AICPA SEC Practice Section's Requirements of Membership (d), (f)(first sentence), (l), (m), (n)(1) and (o), as in existence on April 16, 2003 (AICPA SEC Practice Section Manual – 1000.08(d), (f), (j), (m), (n)(1) and (o)).

Note: The second sentence of requirement (f) of the AICPA SEC Practice Section's Requirements of Membership provided for the AICPA's peer review committee to "authorize alternative procedures" when the requirement for a concurring review could not be met because of the size of the firm. This provision is not adopted as part of the Board's Interim Quality Control Standards. After the effective date of the Interim Quality Control Standards, requests for authorization of alternative procedures to a concurring review may, however, be directed to the Board.

Note: The Board intends that, during the period preceding the mandatory registration date, the Interim Quality Control Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

[PCAOB Release No. 2003-026, *Technical Amendments to Interim Standards Rules*, amends Rule 3400T. See Release No. 2003-026 for language of the amendment.]

RULE 3500T. Interim Ethics Standards.

In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with ethics standards, as described in the AICPA's Code of Professional Conduct Rule 102, and interpretations and rulings thereunder, as in existence on April 16, 2003 (AICPA Professional Standards, ET §§ 102 and 191 (AICPA 2002)).

Note: The Board intends that, during the period preceding the mandatory registration date, the Interim Ethics Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

[PCAOB Release No. 2003-026, *Technical Amendments to Interim Standards Rules*, amends Rule 3500T. See Release No. 2003-026 for language of the amendment.]

RULE 3600T. Interim Independence Standards.

In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with independence standards—

(1) as described in the AICPA's Code of Professional Conduct Rule 101, and interpretations and rulings thereunder, as in existence on April 16, 2003 (AICPA Professional Standards, ET §§ 101 and 191 (AICPA 2002)); and

(2) Standards Nos. 1, 2, and 3, and Interpretations 99-1, 00-1, and 00-2, of the Independence Standards Board.

Note: The Board's Interim Independence Standards do not supercede the Commission's auditor independence rules. See Rule 2-01 of Reg. S-X, 17 C.F.R. 240.2-01. Therefore, to the extent that a provision of the Commission's rule is more restrictive—or less restrictive—than the Board's Interim Independence Standards, a registered public accounting firm must comply with the more restrictive rule.

Note: The Board intends that, during the period preceding the mandatory registration date, the Interim Independence Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

[PCAOB Release No. 2003-026, *Technical Amendments to Interim Standards Rules*, amends Rule 3600T. See Release No. 2003-026 for language of the amendment.]

Appendix 2

Section-by-Section Analysis of Rules Relating to Interim Professional Auditing Standards

The rules relating to interim professional auditing standards consist of PCAOB Rules 3200T, 3300T, 3400T, 3500T and 3600T. Each of the rules is discussed below.

Rule 3200T—Interim Auditing Standards

Rule 3200T provides that, in connection with the preparation or issuance of any audit report on the financial statements of an issuer, a registered public accounting firm shall comply with generally accepted auditing standards as described in the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's ("ASB") Statement on Auditing Standards ("SAS") No. 95, as in existence on April 16, 2003. SAS No. 95 describes the relative authority of various sources of generally accepted auditing standards. Specifically, SAS No. 95 describes the ten general, field work and reporting standards approved by the membership of the AICPA, and amended by the ASB, and the Statements on Auditing Standards approved by the ASB, as standards with which an auditor is required to comply.[1] As of April 16, 2003, 101 SASs had been issued by the ASB.

Statement of Auditing Standards No. 95 also provides that an "auditor should be aware of and consider" certain interpretive publications, such as the ASB's Interpretations of the SASs, auditing guidance included in AICPA Audit and Accounting Guides, and AICPA auditing Statements of Position. While these interpretive publications have not been accorded the same authority as the ten GAAS or the SASs, SAS No. 95 requires that, if an auditor does not comply with the guidance in these publications, "the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance." Finally, SAS No. 95 also recognizes that other auditing publications "may help the auditor understand and apply the SASs." The Board's Rule 3200T provisionally adopts this framework.

As the Note to Rule 3200T clarifies, under Section 102(a) of the Act, public accounting firms that want to continue to audit issuers are not required to be registered with the Board until 180 days after the date of the determination of the Commission under section 101(d) that the Board has the capacity to carry out the requirements of Title I of the Act (the "mandatory registration date"). The Board intends that, during the period preceding the mandatory registration date, the Interim Auditing Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

Rule 3300T—Interim Attestation Standards

Rule 3300T governs the conduct of engagements that (i) are described in the ASB's Statement on Standards for Attestation Engagements No. 10 (Codification of Statements on Auditing Standards, AT § 101.01), and (ii) relate

[1] SAS No. 95, Codification of Statements on Auditing Standards, AU §§ 150.02-150.03. Statement of Auditing Standards No. 95 also provides that "[t]he auditor should be prepared to justify departures from the SASs."

to the preparation or issuance of audit reports for issuers. Registered public accounting firms involved in such engagements are required to comply with the ASB's Statements on Standards for Attestation Engagements, and related interpretations and AICPA Statements of Position, as in existence on April 16, 2003.

As the Note to Rule 3300T clarifies, the Board intends that, during the period preceding the mandatory registration date, the Interim Attestation Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

Rule 3400T—Interim Quality Control Standards

Rule 3400T sets forth minimum quality control standards with which registered public accounting firms must comply, in order to ensure that registered public accounting firms, and their personnel, comply with applicable accounting and auditing (and other professional) standards. Through Rule 3400T, the Board has provisionally designated the Statements on Quality Control Standards proposed and issued by the ASB and certain AICPA SEC Practice Section ("SECPS") membership requirements, as they existed, and as they applied to SEC Practice Section members, on April 16, 2003, as the Board's Interim Quality Control Standards. Because the Board intends the Interim Quality Control Standards to preserve existing standards as they applied on April 16, consistent with Section 103(a)(3) of the Act, those Interim Quality Control Standards adapted from the AICPA SEC Practice Section requirements apply only to those firms that are members of the AICPA SEC Practice Section.[2]

The ASB's Statements on Quality Control Standards are published in the AICPA's Professional Standards, at QC Sections 20–40. The provisions of the AICPA's SECPS membership requirements that have been incorporated into the Board's Interim Quality Control Standards are Membership Requirements (d), (f) (first sentence), (l), (m), (n)(1) and (o), and referenced appendices, which are published in the AICPA's SEC Practice Section Reference Manual §1000.08. The SECPS membership requirements that are incorporated into the Board's Interim Quality Control Standards provide as follows:

- Requirement (d) requires registered public accounting firms to "ensure that all professionals in the firm residing in the United States, including CPAs and non-CPAs, participate in at least 20 hours of qualifying continuing professional education (CPE) every year and at least 120 hours every three years. . . . [P]rofessionals who devote at least 25% of their time to performing audit, review or other attest engagements (excluding compilations), or who have the partner/manager-level responsibility for the overall supervision or review of any such engagements, must obtain at least 40% (eight hours in any one year and 48 hours every three years) of their required CPE in subjects relating to accounting and auditing."
- Requirement (f) requires registered public accounting firms to "establish policies and procedures that meet the requirements set forth in the SECPS Reference Manual, for a concurring review of the audit report and the financial statements by a partner other

[2] In the future the Board may, by rulemaking and pursuant to its standards-setting procedures, extend the AICPA SEC Practice Section requirements to other registered public accounting firms.

than the audit partner-in-charge of an SEC engagement before issuance of an audit report on the financial statements of an SEC engagement and before the re-issuance of such an audit report where the performance of subsequent events procedures is required by professional standards." After the effective date of the Interim Quality Control Standards, requests for authorization of alternative procedures to a concurring review may be sought from the Board. Any such request should be directed to the attention of the Director of Registration and Inspection, 1666 K Street, N.W., Washington, D.C. 20006-2803.

- Requirement (l) requires registered public accounting firms to "communicate through a written statement to all professional firm personnel the broad principles that influence the firm's quality control and operating policies and procedures on, as a minimum, matters related to the recommendation and approval of accounting principles, present and potential client relationships, and the types of services provided, and inform professional firm personnel periodically that compliance with those principles is mandatory."

- Requirement (m) requires a registered public accounting firm that has been the auditor of an SEC registrant and has resigned, declined to stand for reelection, or been dismissed, to report the fact that the "relationship has ceased directly in writing to the former SEC client, with a simultaneous copy to the Office of the Chief Accountant of the Securities and Exchange Commission" by the end of the fifth business day following the firm's determination that the relationship has ended, irrespective of whether or not the SEC registrant has reported the change in a timely-filed Form 8-K.

- Requirement (n)(1) requires registered public accounting firms that are "members of, correspondents with, or similarly associated with international firms or international associations of firms," to "seek adoption of policies and procedures by the international organization or individual foreign associated firms that are consistent with the objectives set forth in Appendix K, SECPS § 1000.45."

- Requirement (o) requires registered public accounting firms to ensure that they have "policies and procedures in place to comply" with applicable independence requirements. This requirement further specifically requires firms to establish independence policies covering relationships between the firm, its benefit plans, and its professionals, and restricted entities.

As the Note to Rule 3400T clarifies, the Board intends that, during the period preceding the mandatory registration date, the Interim Quality Control Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

Rule 3500T—Interim Ethics Standards

Rule 3500T sets forth ethics standards for registered public accounting firms and their personnel. Through Rule 3500T, the Board has provisionally designated Rule 101 of the AICPA's Code of Professional Conduct, and interpretations and rulings thereunder, as they existed on April 16, 2003, as the Board's

Interim Ethics Standards. Rule 101, and the AICPA's interpretations and rulings thereunder, are published in AICPA Professional Standards, ET §§ 102 and 191 (AICPA 2002).

As the Note to Rule 3500T clarifies, the Board intends that, during the period preceding the mandatory registration date, the Interim Ethics Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

Rule 3600T—Interim Independence Standards

Rule 3600T sets forth independence standards for registered public accounting firms and their personnel. Through Rule 3600T, the Board has provisionally designated Rule 101 of the AICPA's Code of Professional Conduct, and interpretations and rulings thereunder, as they existed on April 16, 2003, and Standards Nos. 1, 2 and 3, and interpretations 99-1, 00-1, and 00-2 of the Independence Standards Board ("ISB"), as the Board's Interim Independence Standards. Rule 101, and the AICPA's interpretations and rulings thereunder, are published in the AICPA's Professional Standards, at ET Sections 102 and 191. The ISB Standards and interpretations, which are made effective by the SEC's Policy Statement on the Establishment and Improvement of Standards Related to Auditor Independence (FR No. 50A, July 17, 2001), are currently available at www.cpaindependence.org.

The Board's Interim Independence Standards shall not be interpreted to supercede the Commission's independence requirements. Therefore, to the extent that a provision of the Commission's rule or policy is more restrictive—or less restrictive—than the Board's Interim Independence Standards, a registered public accounting firm shall comply with the more restrictive requirement.

As the Note to Rule 3600T clarifies, the Board intends that, during the period preceding the mandatory registration date, the Interim Independence Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

PCAOB Release No. 2003-009

Compliance With Auditing and Related Professional Practice Standards—Advisory Groups

PCAOB Release No. 2003–009
June 30, 2003
PCAOB Rulemaking
Docket Matter No. 004

Summary:

After public comment, the Public Company Accounting Oversight Board ("Board" or "PCAOB") has adopted a Rule relating to compliance with the Board's auditing and related professional practice standards and a Rule relating to the formation of advisory groups. Specifically, the Board has adopted Rule 3100, and a related definition that would appear in Rule 1001, and Rule 3700. Rule 3100 generally requires all registered public accounting firms to adhere to the Board's auditing and related professional practice standards in connection with the preparation or issuance of any audit report for an issuer (as defined in the Sarbanes-Oxley Act of 2002 (the "Act")) and in their auditing and related attestation practices. Rule 3700 governs the formation, composition and role of one or more advisory groups to assist the Board in formulating new auditing and related professional practice standards for registered public accounting firms. The Board will submit these Rules to the Securities and Exchange Commission ("Commission" or "SEC") for its approval pursuant to Section 107 of the Act. These Rules will not take effect unless approved by the Commission pursuant to Section 107 of the Act. This Release also provides additional guidance regarding the number, size and composition of advisory groups and addresses certain qualifications that the Board may consider in selecting advisory group members and the terms and conditions of membership. Further, it provides guidance about the advisory group meetings, agendas, role of members and procedures that the Board believes is important to the functioning of advisory groups.

Public Comment:

The Board released for public comment proposed Rules on the establishment of auditing and other professional standards on April 18, 2003. The Board received 22 letters of comment.

Board Contacts:

Gordon Seymour, Acting General Counsel (202/207-9034; seymourg@pcaobus.org), Thomas Ray, Deputy Chief Auditor (202/207-9112; rayt@pcaobus.org), or Mary M. Sjoquist, Special Counsel to Board Member Gradison (202/207-9084; sjoquistm@pcaobus.org).

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Section 103(a)(1) of the Act directs the Board to establish auditing and related attestation standards, quality control standards, and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by the Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors. Similarly, Section 103(b) authorizes the Board to establish such rules as may be necessary or appropriate to implement the auditor independence requirements in, or as authorized under, Title II of the Act. While Section 103(a)(4) directs the Board to convene such expert advisory groups as may be appropriate to aid in standards-setting, it nevertheless affords the Board considerable discretion in determining the procedures by which it will develop and adopt auditing and related professional practice standards.[1]

This Release announces the adoption of Rule 3100 (and a related definition) and Rule 3700. Rule 3100 requires all registered public accounting firms to adhere to the Board's auditing (and related attestation), quality control, and ethics standards, and its independence standards. Rule 3700 addresses the formation, composition, and other basic matters concerning advisory groups, which may be convened to aid in the Board's standards-setting process. In addition, as set forth in more detail below, the Board has determined to convene, at this time, one standing advisory group (the "SAG") to assist it in performing its standards-setting responsibilities.

Section A of this Release discusses the adoption of Rule 3100. Section B discusses the adoption of Rule 3700, and the establishment of the SAG and ad hoc task forces. The text of Rule 3100 (and a related definition) and Rule 3700 and a detailed discussion of the Rules are provided in Appendices 1 and 2 hereto, respectively.

The Board has reviewed all of the public comments received on the Rules as proposed in Release No. 2003-005. In response to these comments, Rule 3100 (and a related definition) and Rule 3700, as finalized, both clarify and modify certain aspects of the proposed Rules. Most importantly, the revisions to the original proposal are as follows—

- Instead of using the term Professional Auditing Standards as originally proposed, the defined term in Rule 1001 has been changed to Auditing and Related Professional Practice Standards;
- Rule 3700(c), Selection of Members of Advisory Groups, has been revised to clarify that the Board will accept nominations to the SAG, including self-nominations, from any person or organization rather than including a nonexclusive list of specific groups; and
- Rule 3700(e), Ethical Duties of Advisory Group Members, has been revised to make EC10 of the Board's Ethics Code applicable to members of the SAG with respect to any private publication or public statement about the Board or any advisory group or any of the activities of the Board or any advisory group.[2]

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[1] The auditing and related attestation standards, quality control standards, and ethics standards over which the Board has authority under Section 103(a) of the Act, and the independence rules the Board is authorized to adopt under Section 103(b), are collectively referred to in this Release as "auditing and related professional practice standards." This term is defined in Rule 1001(a)(viii). The Board's proposed Rules and Release used the term "professional auditing standards." As discussed in more detail in Appendix 2 to this Release, because a number of commenters found this term confusing, the Board has decided to use the term "auditing and related professional practice standards" (hereinafter, "Standards").

[2] See PCAOB Release No. 2003-008 (June 30, 2003) which includes the entire text of the Board's Ethics Code.

A more detailed analysis of the Board's response to the comments on the proposed Rules is included in Appendix 2. The Board's Rules will be submitted to the Commission for approval. Pursuant to Section 107 of the Act, Board Rules do not take effect unless approved by the Commission.

A. Compliance With the Board's Auditing and Related Professional Standards

Section 103(a) of the Act directs the Board, by rule, to establish auditing and related attestation standards, quality control standards, and ethics standards "to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by [the] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." Section 103(b) of the Act also directs the Board to establish independence standards to implement, or as authorized under, Title II of the Act.[3]

As a corollary to the Board's exclusive, statutory authority to establish and amend Standards, all public accounting firms that are registered with the Board must comply with the Board's Standards. While this requirement is implicit in the Act, the Board has codified the obligation of registered firms to comply with the Board's Standards in Rule 3100. Any registered public accounting firm or person associated with such a firm that fails to adhere to applicable Board Standards may be the subject of a Board disciplinary proceeding in accordance with Section 105 of the Act.[4] In general, the Board's Standards will apply to registered public accounting firms and their associated persons in connection with their audits of (and related attestations concerning) the financial statements of issuers, as defined in Section 2(a)(7) of the Act, and those firms' auditing and related attestation practices. A number of commenters suggested that this Rule was either beyond the Board's authority or would create the impression that it applied to areas outside the Board's authority. To address these concerns, commenters suggested adding language about the scope of the Board's authority to Rule 3100. After considering these comments, the Board has decided to adopt the Rule as proposed.

The Board recognizes its responsibility to oversee the audits of issuers, as that term is defined in the Act, and does not intend to suggest that registered public accounting firms and their associated persons must comply with the Board's Standards in auditing non-issuers. Rule 3100, however, requires registered public accounting firms and their associated persons to comply with all *applicable* Standards. Accordingly, if the Board's Standards do not apply to an engagement or other activity of the firm, Rule 3100, by its own terms, does not apply to that engagement or activity.

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[3] See also Report of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, on S. 2673, S. Rep. No. 107-205 (July 26, 2002) ("The Committee has concluded that the Board's plenary authority in this area is essential for the Board's effective operation, a position taken during the hearings by a number of witnesses..."). Board Rules adopting or modifying auditing and related professional practice standards require approval by the Commission. In addition, the Board recognizes that the Commission may also establish professional standards applicable to accountants that practice before it and audit reports filed with it and that the Commission has the authority to institute proceedings to amend the Board's Rules, including those that establish auditing and related professional practice standards. See Sections 2(a)(10), 3(c)(2), and 107(b)(5) of the Act.

[4] In addition, the Act provides that any violation of the Board's Rules is to be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934, 15 U.S.C. 78a et seq., or the rules and regulations issued thereunder, and any person violating the Board's Rules "shall be subject to the same penalties, and to the same extent, as for a violation of [the Exchange] Act or such rules or regulations." Section 3(b)(1) of the Act.

Authorities other than the Board may nevertheless require that accounting firms or individual auditors comply with the Board's Standards in the conduct of audits of (or attestations concerning) the financial statements of non-issuers.[5] In that event, those authorities may enforce the Board's Standards pursuant to their own processes.

B. Establishment of Advisory Groups and Ad Hoc Task Forces

While the Board will, by rule, establish Standards, it recognizes that the development of such Standards should be an open, public process in which investors, the accounting profession, the preparers of financial statements, and others will have the opportunity to participate. To this end, as discussed in PCAOB Release No. 2003-005 (April 18, 2003), the Board intends to provide for a public comment process on proposed standards.[6] The Board's staff will, of course, be actively involved in the standards-setting process, but the Board also encourages proposals and recommendations on its standards-setting agenda and standards development projects from the public. Moreover, in order to obtain the advice of a broad range of experts, the Board has determined to form an advisory group, the SAG, which may be divided into sub-groups by the Board if the need for specialized advice arises. Finally, the Board may also establish one or more ad hoc task forces to assist the staff with the drafting of technical language, among other things.

1. Authority

Section 103(a)(4) of the Act provides that the Board shall "convene, or authorize its staff to convene, such expert advisory groups as may be appropriate... to make recommendations concerning the content (including proposed drafts) of auditing, quality control, ethics, independence, or other standards required to be established under this section." The Board has decided initially that it is likely to exercise this authority by convening the SAG to participate in the standards-setting process. Rule 3700 addresses the formation, composition, and other basic matters concerning advisory groups, including the SAG.

2. Role, Size and Composition

The role of the SAG will be to assist the Board in *reviewing* existing Standards, in *evaluating* proposed Standards recommended by Board staff, Board-formed technical task forces or others and *recommending* to the Board new or amended Standards. The role of the SAG will not ordinarily include technical drafting (which will be performed by the Board's staff, with the assistance of ad hoc task forces, when necessary). Instead, the Board will look to the SAG to provide advice and insight as to the need to formulate new Standards or change existing Standards and opinions on the impact of proposed new or changed Standards.

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[5] Cf. Section 209 of the Act (stating that "[i]n supervising nonregistered public accounting firms and their associated persons, appropriate State regulatory authorities should make an independent determination of the proper standards applicable...").

[6] In response to PCAOB Release No. 2003-005, the Board received several comments relating to the process by which the Board will establish standards. While this release is intended to address only the adoption of Rules 3100 and 3700, the Board will nevertheless take these comments into consideration in its standards-setting work.

The Board contemplates that the SAG initially will have approximately 25 members. As noted above, the Board may, based on the circumstances of particular projects, prior to or after the formation of the SAG, form ad hoc task forces of specially qualified persons selected by the Board to assist it with specific projects. Members of any appointed ad hoc task force may or may not be members of the SAG.

The SAG will be composed of individuals with a variety of backgrounds, including practicing auditors, preparers of financial statements, investors (both individual and institutional), and others.[7] In order to achieve this diversity, the Board expects that no one field of expertise will predominate among the SAG membership. Although SAG members may be employed or otherwise affiliated with particular organizations, the Board expects SAG members to serve in their individual capacities and not to serve as representatives of particular interests, groups or employers.

3. Nominations of SAG Members

In determining appointments to the SAG, the Board intends to solicit nominations, including self-nominations. Interested parties will have 45 days from the date of the Board's Notice ("Notice") to the public to submit nominations on a form which will be provided in the Notice. Interested parties who have submitted nominations prior to the publication of the Notice, will be sent nomination forms for completion at the time of publication of the Notice.

4. Qualifications

In evaluating nominations for the SAG, the Board will seek individuals with an interest in the quality of the audits of public companies. The Board may also consider certain factors in determining SAG appointments including but not limited to the following—

a. SAG members will be individuals of integrity, with an understanding of the responsibilities for and the nature of financial disclosure required under the securities laws and the obligations of accountants with respect to the preparation of and issuance of audit reports with respect to such disclosures; and

b. SAG members will have a working knowledge of one or more of the following subjects and a general understanding of the remaining subjects—

- generally accepted auditing standards (as developed by previous auditing standards setting bodies and adopted by the Board as Standards and, in the future, as set from time to time by the Board);
- generally accepted accounting principles;
- the creation, audit or analysis of public financial statements;
- public company corporate governance; and
- other fields that the Board deems to be relevant.

[7] The Board also anticipates appointing individuals from academia and state accounting regulators, among others, to the SAG.

5. Term

Unless the appointment is revoked for cause, as determined by the Board, or unless the SAG member voluntarily resigns from the SAG, membership on the SAG will be for a term of two years; provided, however, that approximately 50 percent of the initial members will be appointed for a three-year term to assure continuity. Members will not be limited in the number of terms that they may serve.

6. Conditions of Membership

Rule 3700(d) specifically states that members of the SAG will serve in their individual capacities and therefore may not delegate their duties, including attendance at meetings, as SAG members. In addition, each appointee to the SAG shall agree in writing to the following "conditions of membership" in order to avoid potential conflicts of interest and to assure that the Board's standards-setting agenda is met—

a. to serve on a voluntary basis without compensation from the Board;[8]

b. to seek constructive resolutions to issues raised by the Board for the SAG;

c. to act in the public interest in his or her individual capacity and not as a representative of any constituency;

d. to attend at least 75 percent of all SAG meetings;[9]

e. to agree to spend, at an expected minimum, between 50 and 100 hours per year on SAG matters or such reasonably greater amount of time as may be necessary to achieve the goals of the SAG and the Board;[10]

f. to refrain from using his or her position on the SAG to influence Board members or Board staff on matters directly affecting that SAG member or his or her employer, business partners or clients;[11]

g. to recuse himself or herself, or otherwise withdraw from, consideration of any matter before the SAG or the Board directly affecting such SAG member, his or her employer, business partners or clients. If recusal or withdrawal is not practical in either such member's or the Board's opinion, such SAG member shall resign from the SAG;[12]

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[8] SAG members shall be entitled to reimbursement for documented reasonable travel expenses relating to participation in official SAG meetings or other SAG activities.

[9] Attendance may be in person or by telephone or teleconference. SAG members who fail to participate in the minimum number of meetings shall be subject to removal by the Board unless excused from attendance by the Chair of the SAG for good reason.

[10] During the first year of the SAG, members may expect to spend more than the minimum number of hours on SAG matters.

[11] SAG members are not precluded from appearing or practicing before the Board regarding matters generally affecting all issuers or registered public accounting firms, including, indirectly, the member, his or her employer, business partners or clients. Accordingly, a SAG member who is employed by a registered public accounting firm would be permitted to be involved in preparing a comment on a Board rule proposal that generally affects all issuers or registered public accounting firms.

[12] Matters generally affecting issuers or registered public accounting firms, even though affecting the SAG member, his or her employer, business partners or clients, shall not require the member to

(continued)

h. to be bound by EC3, EC8(a), EC9, and, with respect to any private publication or public statement regarding the Board or the SAG or any of the activities of the Board or the SAG, EC10 of the Board's Ethics code;[13]

i. to annually certify his or her continuing compliance with "the conditions of membership;" and

j. to agree to any such other provisions that the Board may deem necessary to avoid even the appearance of a conflict of interest.

7. Meetings and Board Relations

The Board has determined that the first Chair of the SAG will be the Board's Chief Auditor and Director of Professional Standards who will be a non-voting member of the SAG. The Board will approve the agenda for all annual, semi-annual or quarterly SAG meetings as set forth below. Agenda items may also be added where the Board determines that the assistance of the SAG is required in response to emerging issues or problems. The Chair will be responsible for preparing the meeting agenda, organizing and overseeing meetings, conference calls and related activities, acting as the general liaison to the Board and finalizing all submissions to the Board based on the SAG recommendations.

The SAG will hold an annual meeting to discuss the agenda presented to the SAG on the annual standards-setting process and related matters. The SAG will also hold a semi-annual meeting. Both the annual and the semi-annual meetings will be open to the public. Meetings of the SAG may also be held, at the direction of the Board or the Chair, during the intervening quarters. In addition, at the direction of the Chair, monthly meetings of the SAG may be held, by video or teleconference, for the Board's staff to report on new issues raised by the Board for the SAG's consideration and to discuss the status of pending issues. Final decisions on recommendations to the Board and related activities will be conducted at the annual, semi-annual, or other open meeting of the SAG.[14] The meetings held in the quarters between the annual and semi-annual meeting, if any, and the monthly meetings will not generally be open to the public.

If so directed by the Chair of the SAG, the SAG may convene hearings, roundtable discussions or other fact-finding activities designed to assist the SAG in the development of recommendations on new or amended Standards or other recommendations to the Board.

Decisions on whether a recommendation should be made to the Board will be by a majority of the SAG members present in person or by video or teleconference. Recommendations from the SAG will be presented to the Board at an

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(footnote continued)

recuse or withdraw him or herself from consideration of the matter or to resign from SAG. The Board expects that most standards-setting projects will affect issuers (or categories of issuers) and registered public accounting firms and their associated persons in a generally similar manner; however, if a standard would have a unique or disproportionate effect on a particular issuer or firm, a SAG member employed by that issuer or firm would be required under Rule 3700 to recuse himself or herself.

[13] In PCAOB Release No. 2003-008 (June 30, 2003), the Board clarified that for purposes of applying EC8(a) to SAG members, the SAG members shall not be considered to lack independence or objectivity with regard to SAG matters merely because they (or their employer, business partners or clients) are subject to the direct or indirect oversight of the Board.

[14] The Board expects the SAG to make decisions in an efficient and speedy manner. To this end, the SAG need not defer decisions on recommendations for the annual or semi-annual open meetings. Rather, at the direction of the Chair, the SAG may make decisions on recommendations at any meeting, so long as it is open to the public in some manner, including, at the direction of the Chair, telephonically.

open meeting of the Board. Such recommendations will be provided in writing, including dissenting opinions, if any, by SAG members. The Board retains the exclusive authority to adopt, modify, or reject any SAG recommendation, in its sole discretion, in order to protect investors by improving the fairness and reliability of corporate disclosures as set forth in the Act.

* * * * * *

On the 30th day of June, in the year 2003, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Acting Secretary
June 30, 2003

APPENDICES—

1. Rules Relating to Auditing and Related Professional Practice Standards and Advisory Groups
2. Section-by-Section Analysis of Rules Relating to Auditing and Related Professional Practice Standards and Advisory Groups

Appendix 1

Rules Relating to Auditing and Related Professional Practice Standards and Advisory Groups

RULES OF THE BOARD

SECTION 1. GENERAL PROVISIONS

Rule 1001. Definitions of Terms Employed in Rules.

When used in the Rules, unless the context otherwise requires:

(a)(viii) Auditing and Related Professional Practice Standards.

The term "auditing and related professional practice standards" means the auditing standards, related attestation standards, quality control standards, ethical standards, and independence standards (including any rules implementing Title II of the Act), and any other professional standards, that are established or adopted by the Board under Section 103 of the Act.

SECTION 7. PROFESSIONAL STANDARDS

Part 1—General Requirements

Rule 3100. Compliance With Auditing and Related Professional Practice Standards.

A registered public accounting firm and its associated persons shall comply with all applicable auditing and related professional practice standards.

Part 7—Establishment of Professional Standards

Rule 3700. Advisory Groups.

a. Formation.

To assist it in carrying out its responsibility to establish auditing and related professional practice standards, the Board will convene one or more advisory groups, in accordance with Section 103(a)(4) of the Act.

b. Composition.

Advisory groups, in combination or as sub-groups designated by the Board within one advisory group, will contain individuals with expertise in one or more of the following areas—

1. accounting;
2. auditing;
3. corporate finance;
4. corporate governance;
5. investing in public companies; and
6. other areas that the Board deems to be relevant to one or more auditing or related professional practice standards.

c. Selection of Members of Advisory Groups.

Members of advisory groups will be selected by the Board, in its sole discretion, based upon nominations, including self-nominations, received from any person or organization.

Note: The Board will announce, from time to time, periods during which it will receive nominations to an advisory group. During those periods, nominations may be submitted by any person or organization, including, but not limited to, any investor, any accounting firm, any issuer, and any institution of higher learning.

d. Personal Membership.

Membership in an advisory group will be personal to the individuals selected to serve on the advisory group. A member's functions and responsibilities, including attendance at meetings, may not be delegated to others.

e. Ethical Duties of Advisory Group Members.

Members of an advisory group shall comply with EC3, EC8(a), EC9, and, with respect to any private publication or public statement about the Board or any advisory group or any of the activities of the Board or any advisory group, EC10 of the Board's Ethics Code.

f. Ad Hoc Task Forces.

The Board may, in its discretion, establish ad hoc task forces. The membership of such task forces may include, but is not limited to, advisory group members. To the extent not otherwise required, members of ad hoc task forces shall comply with paragraph (e) of this Rule.

Appendix 2

Section-by-Section Analysis of Rules Relating to Auditing and Related Professional Practice Standards and Advisory Groups

Rules Relating to Auditing and Related Professional Practice Standards

The Rules relating to auditing and related professional practice standards consist of Rule 3100, plus a new definition that appears in Rule 1001. Each of the Rules, and the new definition, is discussed below.

Rule 1001—Definitions of Terms Employed in Rules.

Rule 1001 contains definitions of terms used in the Board's Rules.

Auditing and related professional practice standards

Rule 1001(a)(viii) defines "auditing and related professional practice standards" as the auditing standards, related attestation standards, quality control standards, ethical standards, and independence standards (including any rules implementing Title II of the Act), and any other professional standards, that are established or adopted by the Board under Section 103 of the Act.

The Board had proposed to use "professional auditing standards" as the term defined in this provision. Several commenters expressed concern that characterizing attestation, quality control, ethical, and independence standards as "professional auditing standards" would confuse people as to the defined term's meaning. To address these concerns, the Board has chosen to use the term "auditing and related professional practice standards" as the defined term for the standards established or adopted by the Board under Section 103 of the Act. The Board has used the longer term "auditing and related professional practice standards," rather than the shorter "professional standards," because the term "professional standards" is defined otherwise in Section 2(a)(10) of the Act. The term "auditing and related professional practice standards" is similar to that portion of the definition of the term "professional standards" that appears in Section 2(a)(10)(B) of the Act. (Hereinafter in this Section-by- Section Analysis, auditing and related professional practice standards shall be referred to as "Standards.")

In addition, the Board's proposed definition was based on a portion of the definition of "professional standards" in Section 2(a)(10)(B) of the Act. For purposes of clarity, the Board has modified this definition slightly to track more closely the description of the standards the Board will set in Section 103(a)(1) of the Act. The definition still includes any other type of standard provided for in the definition of "professional standards" in Section 2(a)(10)(B) of the Act that the Board establishes or adopts under Section 103 of the Act. Accordingly, the definition, as revised, covers the same scope of standards as the Board's proposed rule.

Rule 3100—Auditing and Related Professional Practice Standards Applicable to Registered Public Accounting Firms.

Rule 3100 provides that a registered public accounting firm and its associated persons must comply with all applicable Standards.[1] This Rule is intended to codify the obligation of registered public accounting firms and their associated persons to comply with applicable Standards and to ensure that the Board's Standards are enforceable.

A number of commenters suggested that this Rule was either beyond the Board's authority or would create the impression that the Rule applied to areas outside the Board's authority. To address these concerns, commenters suggested adding language about the scope of the Board's authority to Rule 3100. After considering these comments, the Board has decided to adopt the Rule as proposed.

The Board recognizes its responsibility to oversee the audits of issuers, as that term is defined in the Act, and does not intend to suggest that registered public accounting firms and their associated persons must comply with the Board's Standards in auditing non-issuers. Rule 3100, however, requires registered public accounting firms and their associated persons to comply with all *applicable* Standards. Accordingly, if the Board's Standards do not apply to an engagement or other activity of the firm, Rule 3100, by its own terms, does not apply to that engagement or activity.[2]

Finally, one commenter suggested that Rule 3100 also require registered public accounting firms and their associated person to be duly licensed, registered or permitted or otherwise to hold valid practice privileges and be in good standing under the laws of each applicable state. Registration with the Board does not supersede state registration or licensing requirements and the Board expects registered public accounting firms and their associated persons to comply with state and other applicable legal requirements. Rule 3100, however, is merely intended to codify the obligation of registered public accounting firms and their associated persons to comply with Board Standards and to ensure that the Board's Standards are enforceable. Accordingly, the Board has decided not to amend the Rule as proposed to reflect this suggestion.

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[1] The Board's proposed rule included a note to clarify that proposed Rule 3100 was intended to apply to those public accounting firms that will be required to register with the Board immediately after the applicable date in order to continue to participate in the audits of issuers after such date. For U.S. public accounting firms the applicable date is October 22, 2003. Because of the approaching registration deadline, and because the Board's Interim Auditing Standards, as approved by the SEC, currently require these public accounting firms to comply with them, the Board has deleted the note as unnecessary.

[2] For example, the Board's Interim Auditing Standards provide that, "[i]n connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement of Auditing Standards No. 95, as in existence on April 16, 2003 (Codification of Statements on Auditing Standards, AU § 150 (AICPA 2002))." See Rule 3200T. The term "audit report" is defined in the Act and the Board's Rules to mean the audit of an issuer. See Rule 1001(a)(vi), adopted by the Board in PCAOB Release. No. 2003-007. Moreover, the Board notes that it would not be a correct description of its authority to say, as one commenter suggested Rule 3100 provide, that "A registered public accounting firm and its associated persons shall comply with all applicable professional auditing standards *in performing an audit of an issuer.*" Particularly with respect to the quality control standards the Board is authorized to establish, the Board may adopt standards that, while related to registered public accounting firms' audit practices, must be complied with other than in the course of performing an audit. Cf. Section 103(a)(2)(B) of the Act (requiring the Board to include, among the "quality control standards that it adopts with respect to the issuance of audit reports, requirements... relating to...hiring, professional development, and advancement of personnel").

Rules Relating to Advisory Groups

Rule 3700—Advisory Groups.

Rule 3700 addresses certain basic matters concerning the formation and use of advisory groups in the Board's standards-setting process.[3] The Rule provides that the Board will convene one or more advisory groups, as contemplated in Section 103(a)(4) of the Act. Any advisory group will consist of individuals with expertise in certain, specified areas relevant to the Board's standards-setting responsibilities. Members of an advisory group will be selected by the Board. In addition, the Rule provides for the Board to establish ad hoc task forces.[4] While such task forces may include advisory group members, a task force may consist totally or partially of non-advisory group members who are persons with specialized experience in the standard-setting project under study. To the extent persons who serve on such task forces are not advisory group members or professional staff of the Board, they must comply with the ethics provisions applicable to advisory group members under Rule 3700(e).

The Rule further provides that membership on an advisory group will be personal to the individuals selected and that the functions of an advisory group member, including attendance at meetings, may not be delegated to others. This provision is based on a comparable provision in the Financial Accounting Standards Board's Rules governing the members of the Financial Accounting Standards Advisory Council.

Finally, Rule 3700 provides that members of a Board advisory group must comply with certain provisions in the Board's Ethics Code. Specifically, the Rule makes advisory group members subject to EC3, EC8(a) and EC9, and, to the extent applicable, EC10. These provisions of the Board's Ethics Code address, respectively, general ethical principles applicable to service for the Board, disqualification in the case of conflicts of interest, the non-disclosure of non-public information, and speaking for the Board when not authorized to do so by the Board.[5]

Commenters suggested that it might be appropriate to establish more than one advisory group since expertise is likely to be required in more than one specialized area. The Board is aware that it may need advice in one or more specialized area. However, the Board has determined to form only one standing advisory group (the "SAG"). This group, however, may, at the Board's direction, form specialized subgroups as needed. In addition, the Board may form ad hoc task forces to work with Board staff in formulating Standards in specialized areas which may then, in the Board's discretion, be added to the SAG's agenda for discussion at SAG meetings.

In addition, Commenters recommended adding other specific groups from which nominations could be received to the groups identified in Rule 3700(c) as proposed. After careful consideration of these comments, the Board has determined that Rule 3700(c) should reflect the Board's intention to accept nominations from all sources. Accordingly, Rule 3700(c) has been revised to state that the Board will accept nominations from any person or organization, including self-nominations. A note to this part of Rule 3700 provides that the Board will

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[3] The Rule does not address the use of an advisory group for matters other than standards-setting.

[4] Such task forces may be formed without regard to the procedures for the formation, composition, and selection of advisory group members under Rule 3700(a)–(c).

[5] See PCAOB Release No. 2003-008 (June 30, 2003) for the text of the Ethics Code adopted by the Board.

announce, from time to time, periods during which it will receive nominations for an advisory group.

With respect to qualifications of the advisory group members, one commenter suggested that all members have qualifications similar to those "requirements set forth for audit committee members in recently issued stock exchange and SEC" rules or proposed rules. The New York Stock Exchange ("NYSE") proposed listing requirements require that all members of audit committees of listed companies be financially literate. In addition, at least one member of the audit committee must meet the definition of an "audit committee financial expert."[6] The NASDAQ Stock Market ("NASDAQ") proposed rules regarding qualifications for service on audit committees require that all audit committee members must be able to read and understand financial statements including a company's balance sheet, income statement, and cash flow statement and that the audit committee have at least one member who meets the definition of an "audit committee financial expert."[7] After considering this comment, the Board has decided to adopt the Rule as proposed by the Board. While Rule 3700 does not specifically state the qualifications each member must have, the Rule does set forth the types of expertise that the Board will look for in advisory group members. In addition, as noted in Section C.4. of this Release, the Board may also consider certain specific qualifications in selecting nominees to the SAG. The Board believes that it will likely select members who, at a minimum, would meet the general qualifications set forth for "all" audit committee members in the proposed Rules of the NYSE and NASDAQ while providing the Board with the flexibility to select members from a broad spectrum of backgrounds to assist it in meeting the requirements of the Act. SAG members will be selected based upon qualifications which will be elicited from them on a nomination form and through the evaluative process.

Furthermore, commenters suggested that the composition of the SAG be flexible because the Board may find that it is unable to attract a sufficient number of qualified members from fields such as finance and investment. In response to this concern, it should be noted that, the Board expects that the SAG will be broadly representative and that no one field of expertise will predominate among the SAG membership. Other concerns regarding composition related to assuring that the SAG have a sufficient number of members with technical expertise including requiring a majority of members to be practicing auditors. Although the Board certainly intends that the SAG have practicing auditors among its members, the Board believes that it is important that the SAG be able to provide advice in a broad range of areas, including technical auditing expertise, and that technical expertise in particular areas may be obtained by forming ad hoc task forces, as needed and as appropriate for particular standards-setting projects. Other commenters recommended that—

a. the four largest auditing firms be represented on the SAG;

b. non-U.S. auditors be represented;

c. the number of members associated with a single firm, company or association be limited;

d. membership be dispersed among those affiliated with firms, companies and associations of various sizes;

e. there be a balance between financial information suppliers (representatives of public companies and auditors) and financial information users (equity and debt investors).

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[6] See SEC Release No. 34-47672; File No. SR-NYSE-2002-33 (April 11, 2003).

[7] See SEC Release No. 34-47516; File No. SR-NASD-2002-141 (March 17, 2003).

As noted above, the Board recognizes the need to have diversity on the SAG and in selecting members will keep diversity in mind while assuring that no one expertise will predominate among the SAG membership.

With respect to the actual functions of the SAG, one commenter, suggested that the SAG be involved in all standards-setting proposals while another commenter recommended that the actual drafting of the Standards fall within the SAG's authority. In order to maintain flexibility in the rulemaking process, the Board has determined not to revise the proposed Rule to reflect these comments. Although the SAG is likely to be involved in the Board's standards-setting process as discussed in the Release, the Board does not intend to make SAG involvement mandatory to every standards-setting project. In addition, the actual drafting of the Standards is likely to be done by the Board's staff assisted by ad hoc task forces where necessary.

Another comment related to recommending that the SAG work toward "harmonizing" international standards. Neither Rule 3100 nor 3700 is intended to address substantive standards-setting issues. Rather the Board intends to address such issues, including cooperation with standards-setters in other jurisdictions, in the future.

Commenters also made recommendations regarding SAG procedural matters. These commenters suggested that the Board address—

a. the process for making recommendations on Standards for consideration by the Board;

b. whether or not SAG meetings would be open to the public;

c. the format and the frequency of the meetings;

d. the process by which the Board will set the SAG's agenda;

e. the appointment of a Chair for the SAG;

f. whether the Board will provide all resources for drafting, editing, monitoring comments and publishing new and amended Standards;

g. the term of appointment to the SAG; and

h. an avenue for minority viewpoints to be expressed in any report or recommendation to the Board.

With the exception of the comment on resources for drafting and publishing new Standards, the Board has addressed all of these comments in Section B.7. of the Release. In summary, the SAG will hold an annual meeting and a semi-annual meeting. Additional meetings may be held in the intervening quarters. Monthly telephonic meetings are also expected to be held at the discretion of the Chair. The annual and semi-annual meetings, and any meeting at which the SAG makes a final decision on a recommendation to the Board, will be open to the public. Agenda items for the SAG will be driven in part by the schedule to be set by the Board for the review of the Interim Auditing Standards. Other agenda items will be added by the Board where the Board determines that a response to emerging issues or problems connected with audits needs to be addressed. The Board has determined that the first Chair of the SAG will be the Board's Chief Auditor and Director of Professional Standards. All SAG members will be appointed for two-year terms except that approximately one-half of the appointees initially appointed to the SAG will be appointed for a three-year term to assure continuity. There will be no limits on the terms that a member of the SAG may serve. The Board anticipates that drafting, editing, monitoring comments and publishing, will be conducted by the Board and its staff. To the extent that the SAG is specifically authorized by the Board to undertake any

of these functions and the expenses have been preapproved by the Board or a staff member delegated by the Board, the Board will cover the SAG's costs.

In response to the issue of whether the SAG's meetings will be open to the public and in order to assure that the public is informed of the SAG's operations, the Board has determined that the annual and semi-annual meetings of the SAG will be open. In addition, decisions on making recommendations to the Board will only be made at an open meeting of the SAG. All recommendations to the Board by the SAG will be presented to the Board in open public meetings of the Board and such presentations will include the presentation of minority views of the SAG members. Finally, it should be noted that Board standards-setting proposals will be subject to the public comment process before being adopted by the Board.

With respect to Rule 3700(e) relating to the ethical duties of the SAG members, one commenter recommended that the SAG members be subject to Section EC14, the certification requirements, of the Ethics Code. In response to this comment, the Board has added to its "conditions of membership" described in Section C of the Release, a requirement that members of the SAG shall annually certify their continuing compliance with the "conditions of membership." A second commenter recommended that both Rule 3700(e) and EC8(a) of the Ethics Code be clarified to confirm that being a practicing auditor does not, in and of itself, constitute a financial interest requiring recusal. Section EC8(a) of the Ethics Code has been revised to add an explanatory note that clarifies this issue.[8] A third commenter recommended that members of the SAG be prohibited from "unauthorized" speaking for the Board. In response to this comment, the Board has revised Rule 3700(e) to make EC10 of the Board's Ethics Code applicable to any private publication or public statement by an advisory group member with regard to the Board or the advisory group or any of the activities of the Board or the advisory group. Finally, a fourth commenter recommended that a member of the SAG be permitted to share SAG material with support personnel within the member's home organization who are assigned to assist the member in his or her duties. The Board has not added a provision to address this concern. The Board believes that SAG members will normally be able to perform their responsibilities without needing access to non-public Board information. To the extent that it may be appropriate, from time to time, to permit non-public standards-setting information to be shared with individuals outside the SAG, including to permit SAG members to consult technical experts who are not employees or staff of the Board, the Board may require that such individuals agree to the confidentiality provisions under Section EC9 of the Ethics Code.

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[8] See PCAOB Release No. 2003-008 (June 30, 2003).

PCAOB Release No. 2003-025

Auditing Standard No. 1, References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board

PCAOB Release No. 2003-025
December 17, 2003
PCAOB Rulemaking
Docket Matter No. 010

Approved by the Securities and Exchange Commission on May 14, 2004, and is effective for audit reports issued or reissued on or after May 24, 2004.

Summary

After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") has adopted Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*. This standard requires registered public accounting firms to include in their reports on engagements performed pursuant to the Board's auditing and related professional practice standards, including audits and reviews of financial statements, a reference to the standards of the Public Company Accounting Oversight Board (United States). The Board will submit this standard to the Securities and Exchange Commission ("Commission" or "SEC") for approval pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 (the "Act"). This standard will not take effect unless approved by the Commission.

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Section 103 of the Act authorizes the PCAOB to establish auditing and related professional practice standards to be used by registered public accounting firms in connection with the preparation and issuance of audit reports as required by the Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors. Consistent with Section 103 of the Act, PCAOB Rule 3100, *Compliance With Auditing and Related Professional Practice Standards*, requires auditors to comply with all applicable auditing and related professional practice standards established by the PCAOB.

Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* directs auditors[1] to state that

[1] Reference in the Board's standards to an "auditor" means a registered public accounting firm, or an associated person of such a firm, as defined in the Act and the Board's rules, unless specifically stated otherwise. Nothing in the Board's rules would preclude an accounting firm from conducting an audit of a company that is not an issuer in accordance with the Board's standards and so stating in its audit report. This is true regardless of whether or not the accounting firm performing the audit is registered with the Board.

the engagement was conducted in accordance with "the standards of the Public Company Accounting Oversight Board (United States)" whenever the auditor has performed the engagement in accordance with the Board's standards.

Section A of this release describes Auditing Standard No. 1. Section B of this release discusses and addresses the comments received on the Board's proposed auditing standard, which the Board released for public comment. The text of Auditing Standard No. 1 is attached to this release as Appendix 1.

A. Description of Auditing Standard No. 1

At the time of this release, the Board's auditing and related professional practice standards consist of the standards described in Rules 3200T through 3600T, which the Board has adopted, on an initial, transitional basis, as interim standards. The standards (with which PCAOB Rule 3100 requires registered public accounting firms, and persons associated with such firms, to comply) include these interim standards and any permanent standards that the Board adopts.

Each of the standards described in Rules 3200T through 3600T was originally adopted by the American Institute of Certified Public Accountants ("AICPA"), a committee thereof, including the Auditing Standards Board ("ASB"), or the Independence Standards Board. Thus the Board's rule on interim auditing standards, Rule 3200T, incorporates "generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, in existence on April 16, 2003" (the "interim standards").[2] These auditing standards were adopted, and from time to time amended, by the ASB, until the Board incorporated them into the Board's interim standards. The interim standards require auditors to include in their reports a reference to the standards that were followed in performing the engagement. These references include "generally accepted auditing standards," "U.S. generally accepted auditing standards," "auditing standards generally accepted in the United States of America," and "standards established by the AICPA."

PCAOB Auditing Standard No. 1 supersedes these references by requiring that auditors' reports on the financial statements of issuers that are issued or reissued, after Auditing Standard No. 1 becomes effective, include a statement that the engagement was conducted in accordance with "the standards of the Public Company Accounting Oversight Board (United States)."[3] This auditing standard is effective for auditors' reports issued or reissued on or after the 10th day following approval of this auditing standard by the Commission. An appendix[4] to this standard provides illustrative reports on an audit of financial statements and a review[5] of interim financial information of a public company.

Once Auditing Standard No. 1 becomes effective, it will require auditors to state that the engagement was performed in accordance with "the standards of the Public Company Accounting Oversight Board (United States)," irrespective of whether the engagement was conducted before or after Auditing Standard No.

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[2] The Board's rules on interim standards were adopted by the Board on April 16, 2003, and approved by the Commission on April 25, 2003. See SEC Rel. No. 33-8222 (April 25, 2003).

[3] See Auditing Standard No. 1 ¶ 3.

[4] Appendices to the Board's standards are an integral part of the standard and carry the same authoritative weight as the body of the standard.

[5] Reviews of the interim financial information are integrally related to audits of financial statements. See generally Statement on Auditing Standards No. 100, *Interim Financial Information* ("SAS No. 100"). For example, SAS No. 100 makes clear that the general standards on auditing discussed in SAS No. 95 "are applicable to a review of interim financial information."

1 becomes effective. Accordingly, auditors who reissue reports that were originally issued before the date that Auditing Standard No. 1 becomes effective, or who issue reports that include comparative financial information that was the subject of an audit or review report that was issued before that date, must nevertheless state that the audit or review was performed in accordance with "the standards of the Public Company Accounting Oversight Board (United States)," if those reports are reissued after Auditing Standard No. 1 becomes effective. The Board believes that a uniform reference to the standards of the PCAOB—even with respect to audits and reviews completed before the PCAOB adopted its interim standards—is appropriate because the interim standards that the Board adopted are the "generally accepted auditing standards" with which auditors were required to comply before the PCAOB adopted its interim standards.

Referring to PCAOB standards in connection with a period that preceded the date of the PCAOB's own adoption of those standards may seem somewhat counterintuitive. The requirement is intended, however, to reflect the fact that the standards in place before the PCAOB adopted its interim standards, without change, became the PCAOB's standards. Indeed, the Board considered whether to require auditors to refer to "generally accepted auditing standards" when reissuing reports that were originally issued before Auditing Standard No. 1 becomes effective, and to refer to "standards of the PCAOB" with respect to reports issued on or after Auditing Standard No. 1 becomes effective.

The Board believes, however, that it is appropriate to describe the "generally accepted auditing standards" that the Board adopted as "standards of the PCAOB." This terminology will reflect the fact that the standards that auditors were required to use before April 25, 2003—i.e., generally accepted auditing standards as they existed on April 16, 2003—became the applicable standards on April 25 and continue to apply to audits of public companies, as the Board amends them. Auditing standards have continuously been amended over time, and auditors have consistently been required to state whether their audits complied with the then-prevailing standards. The substance of the applicable standards for audits and reviews of public company financial statements did not change on April 25, 2003. Rather, April 25, 2003, is significant only because the PCAOB gained authority over such standards on that date. The Board believes it would be inappropriate to create an impression in auditors' reports that engagements performed before Auditing Standard No. 1 becomes effective, or even before April 25, were performed in accordance with a wholly different body of standards, rather than the same body of standards at different points in its evolution.

The Board expects to amend its standards from time to time, just as the ASB amended generally accepted auditing standards from time to time. The Board believes that using a consistent description of standards prevailing at the time an audit or review report is issued—and holding auditors to compliance with those then-prevailing standards—better contributes to the creation of informative audit reports.

Upon adoption of this auditing standard, all references in the interim standards to generally accepted auditing standards, U.S. generally accepted auditing standards, auditing standards generally accepted in the United States of America, and standards established by the AICPA, mean the corresponding standards of the Public Company Accounting Oversight Board. The Act and the Board's rules already require the auditor to comply with the Board's standards. The purpose of this standard is to conform the references in the interim standards to the standards that the Act and Rule 3100 require auditors to use in

connection with preparing and issuing audit and related reports on the financial statements of issuers.

Under the Act, Auditing Standard No. 1 will not be effective unless it is approved by the SEC. By its terms, Auditing Standard No. 1 will be effective for auditors' reports issued or reissued on or after the 10th day following SEC approval of this standard. Until the effective date of this standard, the reporting requirements as described in the AICPA's Codification of Statements on Auditing Standards, are still in effect as interim standards.

B. Public Comment Process and Board Responses

The Board released a proposed auditing standard, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*, for public comment, on November 12, 2003. The Board received eight written comment letters.[6] In response to these comments, the Board's final rules both clarify and modify certain aspects of the proposal, as explained below.

1. Transitional Issues

The Board received several comments related to transitional issues, including, how the proposed standard would affect—

- reissuance of a report originally issued before the proposed standard became effective;
- issuance of a report on comparative financial statements when the audits of the financial statements for periods presented for comparative purposes were conducted before the proposed standard became effective and/or before the Board adopted its interim standards; and
- issuance of a dual-dated report that include dates that straddle the effective date of this standard.

In the proposed standard, the Board had recommended the standard be effective for auditors' reports dated on or after the later of January 1, 2004 or the 10th day after SEC approval of the standard as adopted by the Board. In evaluating the comments with regard to transition, the Board decided to modify the effective date of this standard. Rather than linking the effective date of this standard to the date of the report, this auditing standard will be effective for reports issued or reissued on or after the 10th day following SEC approval of this auditing standard. After this standard becomes effective, any auditor's report issued or reissued with respect to the financial statements of a public company must state that the engagement was performed in accordance with "the standards of the Public Company Accounting Oversight Board (United States)."

One commenter also expressed concern that the proposed standard's requirement that a report state that an audit performed prior to the PCAOB's adoption of interim standards was performed in accordance with PCAOB standards would, in essence, require the auditor to re-audit the prior period's financial statements in order to bring that audit or review into conformity with current PCAOB standards. The Board does not intend to require auditors to bring audits that were performed in accordance with then-prevailing standards into

[6] The comment letters are available on the Board's Web site—www.pcaobus.org—and will be attached to the Board's Form 19b-4, to be filed with the Commission.

conformity with later-prevailing standards in order to reissue a previously-issued report. When the Board adopted as interim standards the generally accepted auditing standards established by the ASB, the Board also adopted the effective dates of those standards. Therefore, reference in auditors' reports to the standards of the PCAOB with respect to financial statements audited or reviewed prior to the effective date of Auditing Standard No. 1 is equivalent to the previously-required reference to generally accepted auditing standards. The reference relates to those standards that were in effect when the audit or review was completed and should not be interpreted to imply a representation that the audit or review complied with standards that became effective after the audit or review was completed. Thus, once Auditing Standard No. 1 becomes effective, a reference to generally accepted auditing standards in reports issued in connection with financial statements of public companies is no longer appropriate or necessary.

2. Applicable Standards of the PCAOB

Several commenters recommended that the Board only require auditors' reports to refer to the *auditing* standards of the PCAOB for audits of financial statements and not to the standards of the PCAOB generally. The Board intends for report references to "the standards of the Public Company Accounting Oversight Board (United States)" to mean those auditing and related professional practice standards that are applicable to the particular engagement. For example, if an issuer does not use any outside service organization that would affect its internal control over financial reporting, then the interim auditing standard on service organizations—described in the Codification of Statements on Auditing Standards at AU § 324 (*Service Organizations*), would not be applicable. On the other hand, the Board's independence standards apply to registered public accounting firms, and associated persons thereof, in connection with the preparation and issuance of audit reports for issuers.

As another example, quality control standards generally apply to a firm's system of quality control over its accounting and auditing practice and not to individual audit engagements. Thus, a breakdown in the system of quality control does not necessarily mean that a particular audit was not conducted in accordance with the standards of the PCAOB. However, such a breakdown might result in a deficient audit if it caused or contributed to an audit deficiency. The determination as to whether a particular auditing or related professional practice standard is applicable in the context of a particular audit is dependent on the nature of the standard in question and on the nature of the engagement at issue.

Thus a reference to "auditing standards" of the PCAOB would be too narrow and preclusive to other standards applicable to the audit. The Board believes that reference to "the standards of the Public Company Accounting Oversight Board (United States)" is a more descriptive reference to the standards applied in the audit.

3. Reference to GAAS

The Board received a number of comments recommending that auditors' reports, with respect to financial statement audits, describe PCAOB standards as generally accepted auditing standards. The notion of general acceptance developed at a time when auditing and accounting standards were not established with the force of law by governmental or other authoritative bodies, but

rather were established by consensus among the members of the accounting profession.

As far as auditing and related professional practice standards are concerned, the Board gained authority to establish such standards by the enactment of the Act. Professional consensus is no longer sufficient to establish auditing standards, and therefore the Board believes that it is no longer appropriate to refer to the standards with which an auditor of the financial statements of a public company must comply as "generally accepted." While those standards may be generally accepted in a variety of contexts, what gives them the force of law in the context of public company audits is adoption by the PCAOB and approval by the SEC.

Therefore, for purposes of any engagement performed in accordance with the applicable auditing and related professional practice standards of the PCAOB, references in the interim standards to generally accepted auditing standards, U.S. generally accepted auditing standards, auditing standards generally accepted in the United States of America, and standards established by the AICPA, mean the standards of the PCAOB.

4. References to Country of Origin and Issuing Office

The Board also received comments recommending that the Board continue to require auditors to state in their reports that the standards according to which they performed their engagements were those standards applicable in the United States. Adopting this recommendation will make it easier for readers of audit reports that are used in cross-border offerings and listings of securities to quickly identify the jurisdiction in which the standards were promulgated. As such, the Board has required in Auditing Standard No. 1 that auditors' reports describe the PCAOB's standards as "the standards of the Public Company Accounting Oversight Board (United States)."

Another commenter recommended that auditors identify in their reports the city and state (or country) of the registered firms issuing the reports. The SEC's rules require disclosure in the auditor's report of the city and state of the accounting firm's office issuing the report.[7] The Board also concurs with this recommendation and, accordingly, has modified the auditing standard and the illustrative reports in the appendix to Auditing Standard No. 1.

5. Other Auditors

The Board was asked to clarify the applicability of this standard, and the Board's standards generally, to circumstances where more than one auditing firm contributes to an audit of a consolidated entity. For example, a firm other than the firm engaged to report on the company's consolidated financial statements may be hired to audit the financial statements of a subsidiary company. In such circumstances, the auditor that conducts the majority of the audit is referred to as the principal auditor and the auditor of the subsidiary company is referred to as the other auditor.[8] Depending on the significance of the portion of the financial statements audited by the other auditor, the principal auditor may divide responsibility with the other auditor by making reference to the audit of the other auditor in his or her report, or the principal auditor may take

[7] 17 C.F.R. § 210.2-02 (2003).

[8] See Codification of Auditing Standards, AU § 543 (AICPA 2002).

responsibility for the work of the other auditor by not making any reference to the other auditor.

In either event, the entire audit must be performed in accordance with the Board's standards. Section 103 of the Act, and the Board's Rule 3100, require registered public accounting firms, and associated persons thereof, to comply with all applicable auditing and related professional practice standards in connection with the preparation and issuance of audit reports on the financial statements of issuers. Whether the other auditor is a registered public accounting firm or an associated person of a registered public accounting firm, the other auditor must comply with the standards of the PCAOB.

6. Applicability to Non-U.S. Firms Not Yet Registered With the Board

Another commenter asked the Board to clarify whether non-U.S. public accounting firms—who are not required to register with the PCAOB until 2004—will be permitted, until registered with the PCAOB, to continue to reference "auditing standards generally accepted in the United States of America" when reporting on an issuer's financial statements. Like the Board's interim standards, with which a public accounting firm is required to comply even before the firm's mandatory registration date, during the period preceding the mandatory registration date, standards of the PCAOB apply to firms engaged in work that requires their registration. Therefore, non-U.S. public accounting firms that have not yet registered, that engage in work that would require them to be registered as of the mandatory registration date, are nevertheless required to reference "the standards of the Public Company Accounting Oversight Board (United States)."

7. Application of Auditing Standard No. 1 to Audit Reports in Connection With Initial Public Offerings

Another commenter recommended that the Board expand the proposed standard to specifically address the various scenarios that auditors will encounter with respect to reporting in conjunction with initial public offerings. The SEC's Rule 3-01 of Regulation S-X requires that, like other SEC filings that must comply with Regulation S-X, a registration statement filed in connection with an initial public offering must include or otherwise incorporate "for the registrant and its subsidiaries consolidated, audited balance sheets as of the end of each of the two most recent fiscal years."[9] In addition, Rule 3-02 of Regulation S-X requires that there "be filed, for the registrant and its subsidiaries consolidated and for its predecessors, audited statements of income and cash flows for each of the three fiscal years preceding the date of the most recent audited balance sheet."[10] The Board understands these provisions to mean that an issuer desiring to register a transaction involving the sale of securities must include balance sheets for the two years preceding the transaction, and income statements and statements of cash flows for the three years preceding the transaction, each audited in accordance with standards as required by the securities laws.

In Section 103 of the Act, Congress has provided the Board authority to establish auditing and related professional practice standards "to be used by registered public accounting firms in the preparation and issuance of audit reports."

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[9] 17 C.F.R. § 210.3-01 (2003).

[10] 17 C.F.R. § 210.3-02 (2003).

In addition, the PCAOB has adopted, and the SEC has approved, PCAOB Rule 3100, which requires registered public accounting firms to comply with all applicable auditing and related professional practice standards of the PCAOB in connection with the preparation and issuance of audit reports on the financial statements of issuers. Accordingly, audit reports on the financial statements of issuers must now comply with—and under Auditing Standard No. 1 auditors must state that they performed the audit in accordance with—the standards of the PCAOB. So long as audits that were performed prior to April 25, 2003, were performed in accordance with then-prevailing generally accepted auditing standards as required by Rule 2-02 of Regulation S-X, an auditor need not reaudit any financial statements that relate to periods preceding April 25, 2003. Further, as discussed above, because the Board adopted the "generally accepted auditing standards" in effect as of April 16, 2003, the Board believes it is appropriate to require auditors who issue or reissue reports on periods prior to the date Auditing Standard No. 1 becomes effective to state that their audits were performed in accordance with PCAOB standards, so long as they were performed in accordance with the "generally accepted auditing standards" prevailing at the time the audits were performed.

* * * * * *

On the 17th day of December, in the year 2003, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Acting Secretary
December 17, 2003

APPENDIX—

References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board

Appendix

References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board

1. The Sarbanes-Oxley Act of 2002 authorized the Public Company Accounting Oversight Board ("PCAOB") to establish auditing and related professional practice standards to be used by registered public accounting firms. PCAOB Rule 3100, *Compliance With Auditing and Related Professional Practice Standards*, requires the auditor to comply with all applicable auditing and related professional practice standards of the PCAOB.

2. The Board has adopted as interim standards, on an initial, transitional basis, the generally accepted auditing standards, described in the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, in existence on April 16, 2003.[1]

3. Accordingly, in connection with any engagement performed in accordance with the auditing and related professional practice standards of the PCAOB, whenever the auditor is required by the interim standards to make reference in a report to generally accepted auditing standards, U.S. generally accepted auditing standards, auditing standards generally accepted in the United States of America, or standards established by the AICPA, the auditor must instead refer to "the standards of the Public Company Accounting Oversight Board (United States)." An auditor must also include the city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued.

4. This auditing standard is effective for auditors' reports issued or reissued on or after the 10th day following approval of this auditing standard by the Securities and Exchange Commission.

5. Audit reports issued prior to the effective date of this standard were required to state that the audits that supported those reports were performed in accordance with generally accepted auditing standards. The PCAOB adopted those generally accepted auditing standards, including their respective effective dates, as they existed on April 16, 2003, as interim standards. Therefore, reference to "the standards of the Public Company Accounting Oversight Board (United States)" with respect to audits of financial statements performed prior to the effective date of this standard is equivalent to the previously-required reference to generally accepted auditing standards. Accordingly, upon adoption of this standard, a reference to generally accepted auditing standards in auditors' reports is no longer appropriate or necessary.

> Note: The term "auditor" in this standard is intended to include both registered public accounting firms and associated persons thereof.

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[1] The Board's rules on interim standards were adopted by the Board on April 16, 2003, and approved by the Commission on April 25, 2003. See SEC Rel. No. 33-8222 (April 25, 2003).

Appendix—Illustrative Reports

1. The following is an illustrative report on an audit of financial statements:

Report of Independent Registered Public Accounting Firm

We have audited the accompanying balance sheets of X Company as of December 31, 20X3 and 20X2, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 20X3. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of [*at*] December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X3, in conformity with U.S. generally accepted accounting principles.

[*Signature*]

[City and State or Country]

[*Date*]

2. The following is an illustrative report on a review of interim financial information:

Report of Independent Registered Public Accounting Firm

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of X Company as of September 30, 20X3 and 20X2, and for the three-month and nine-month periods then ended. This (these) interim financial information (statements) is (are) the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial (statements) for it (them) to be in conformity with U.S. generally accepted accounting principles.

[*Signature*]

[City and State or Country]

[*Date*]

PCAOB Release No. 2003-026

Technical Amendments to Interim Standards Rules

PCAOB Release No. 2003-026
December 17, 2003
PCAOB Rulemaking
Docket Matter No. 011

Summary:

After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") has adopted certain technical amendments to its rules to reflect that the Board will be superseding, or effectively amending, the existing professional standards referred to in the Board's interim standards rules as the Board continues to set auditing and related professional practice standards.

The Board will submit these amendments to the Securities and Exchange Commission ("Commission") for approval pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 (the "Act"). The Board's amendments will not take effect unless approved by the Commission.

Board Contacts

Thomas Ray, Deputy Chief Auditor (202/207-9112; rayt@pcaobus.org), Greg Scates, Associate Chief Auditor (202/207-9114; scatesg@pcaobus.org).

* * *

A. Amendments to the Board's Rules Relating to Interim Standards

On April 16, 2003, the Board adopted on an initial, transitional basis five temporary rules that refer to existing professional standards of auditing, attestation, quality control, ethics, and independence.[1] The amendments approved by the Board reflect that, when the Board adopts a new auditing and related professional practice standard that addresses a subject matter that also is addressed in the interim standards, the affected portion of the interim standards will be superseded or effectively amended. Accordingly, the Board has approved to add the phrase "to the extent not superseded or amended by the Board" to each of the interim standards rules (PCAOB Rules 3200T, 3300T, 3400T, 3500T, and 3600T). In addition, the Board is making technical amendments to Rule 3600T, revising the numbering of the paragraphs from "(1)" and "(2)" to "(*a*)" and "(*b*)". The text of these amendments is presented in the Appendix.

[1] These rules were adopted by the Board on April 16, 2003, and approved by the Securities and Exchange Commission on April 25, 2003. See SEC Rel. No. 33- 8222 (April 25, 2003).

B. Public Comment Process and Board Responses

The Board proposed technical amendments to its interim standards rules and released them for public comment, on November 12, 2003. The Board received six written comment letters.[2] Most of the commenters explicitly indicated support for the technical amendments to the interim standards rules, and none indicated opposition to the technical amendments. In addition, many commenters requested that the Board identify how proposed, as well as final, standards affect the existing interim standards. While it may not always be practicable to identify exactly which portions of existing standards have been superseded or amended by new Board standards, the Board recognizes the need to provide auditors with as much guidance and clarity as possible. As future standards are adopted or amended, the Board intends to identify, to the greatest extent possible, those interim standards that are amended or superseded by standards issued by the Board.

* * *

On the 17th day of December, in the year 2003, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Acting Secretary
December 17, 2003

APPENDIX—

Amendments to Rules Relating to Interim Professional Auditing Standards

[2] The comment letters are available on the Board's Web site—www.pcaobus.org—and will be attached to the Board's Form 19b-4, to be filed with the Commission.

Appendix

Amendments to Rules Relating to Interim Professional Auditing Standards

The Board has amended Section 3 of its rules by inserting the phrase "to the extent not superseded or amended by the Board" in Rules 3200T, 3300T, 3400T, 3500T, and 3600T, and by revising the numbering of the paragraphs in Rule 3600T from "(1)" and "(2)" to "(*a*)" and "(*b*)". The relevant portions of the Rules, as amended, are set out below. Language added by these amendments is shown in bold italics. Deleted paragraph numbers are struck through. Other text in Section 3, including notes to the Rules, remains unchanged and is indicated below by " * * * ".

RULES OF THE BOARD

* * *

SECTION 3. PROFESSIONAL STANDARDS

Part 1 — General Requirements

* * *

Rule 3200T. Interim Auditing Standards.

In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement of Auditing Standards No. 95, as in existence on April 16, 2003 (Codification of Statements on Auditing Standards, AU § 150 (AICPA 2002)), ***to the extent not superseded or amended by the Board***.

* * *

Rule 3300T. Interim Attestation Standards.

In connection with an engagement (i) described in the AICPA's Auditing Standards Board's Statement on Standards for Attestation Engagements No. 10 (Codification of Statements on Auditing Standards, AT § 101.01 (AICPA 2002)) and (ii) related to the preparation or issuance of audit reports for issuers, a registered public accounting firm, and its associated persons, shall comply with the AICPA Auditing Standards Board's Statements on Standards for Attestation Engagements, and related interpretations and Statements of Position, as in existence on April 16, 2003, ***to the extent not superseded or amended by the Board***.

* * *

Rule 3400T. Interim Quality Control Standards.

A registered public accounting firm, and its associated persons, shall comply with quality control standards, as described in—

(*a*) the AICPA's Auditing Standards Board's Statements on Quality Control Standards, as in existence on April 16, 2003 (AICPA Professional Standards, QC §§ 20–40 (AICPA 2002)), ***to the extent not superseded or amended by the Board***; and

(*b*) the AICPA SEC Practice Section's Requirements of Membership (d), (f)(first sentence), (l), (m), (n)(1) and (o), as in existence on April 16, 2003 (AICPA SEC Practice Section Manual § 1000.08(d), (f), (l), (m), (n)(1) and (o))***, to the extent not superseded or amended by the Board***.

* * *

Rule 3500T. Interim Ethics Standards.

In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with ethics standards, as described in the AICPA's Code of Professional Conduct Rule 102, and interpretations and rulings thereunder, as in existence on April 16, 2003 (AICPA Professional Standards, ET §§ 102 and 191 (AICPA 2002))***, to the extent not superseded or amended by the Board***.

* * *

Rule 3600T. Interim Independence Standards.

In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with independence standards—

(~~1~~*a*) as described in the AICPA's Code of Professional Conduct Rule 101, and interpretations and rulings thereunder, as in existence on April 16, 2003 (AICPA Professional Standards, ET §§ 101 and 191 (AICPA 2002)), ***to the extent not superseded or amended by the Board***; and

(~~2~~*b*) Standards Nos. 1, 2, and 3, and Interpretations 99-1, 00-1, and 00-2, of the Independence Standards Board ***to the extent not superseded or amended by the Board***.

* * *

PCAOB Release No. 2004-006

Auditing Standard No. 3, Audit Documentation

PCAOB Release No. 2004-006
June 9, 2003
PCAOB Rulemaking
Docket Matter No. 012

Summary

After public comment, the Public Company Accounting Oversight Board (the "PCAOB" or "Board") has adopted Auditing Standard No. 3, *Audit Documentation*, and an amendment to AU sec. 543 of the Interim Auditing Standards. The Board will submit this standard and amendment to the Securities and Exchange Commission ("SEC" or "Commission") for approval pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 (the "Act"). This standard will not take effect unless approved by the Commission.

Board Contacts

Greg Scates, Associate Chief Auditor (202/207-9114; scatesg@pcaobus.org), and Greg Fletcher, Assistant Chief Auditor (202/207-2203; fletcherg@pcaobus.org).

* * * * * *

Section 103(a)(2)(A)(i) of the Act expressly directs the Board to establish auditing standards that require registered public accounting firms to prepare and maintain, for at least seven years, audit documentation "in sufficient detail to support the conclusions reached" in the auditor's report. Audit documentation is one of only a few topics that the Act expressly requires the Board to adopt standards. Accordingly, the Board made audit documentation a priority in its standards setting responsibilities.

The Board commenced a standards-development project on audit documentation by convening a public roundtable discussion on September 29, 2003, to discuss issues and hear views on audit documentation. Before that roundtable discussion, the Board prepared and released a briefing paper on audit documentation, which posed several questions to help identify the objectives—and the appropriate scope and form—of audit documentation.[1] In addition, the Board asked participants to address specific practice issues relating to, among other things, changes in audit documentation after an audit report has been released; the essential elements and the appropriate amount of detail of audit documentation; the effect on audit documentation of a principal auditor's decision to use the work of other auditors; and retention of audit documentation.

Taking into consideration comments from participants in this roundtable discussion, advice from the Board's staff, and other input, the Board determined

[1] See Briefing Paper for the Roundtable on Audit Documentation, dated September 10, 2003. The transcript of the September 29, 2003 roundtable discussion and copies of the briefing paper are available on the Board's Web site (www.pcaobus.org).

that the existing interim auditing standard on audit documentation was not sufficient in providing direction to ensure that auditors appropriately document both the work they perform and the conclusions they reach in connection with audits and other engagements. On November 21, 2003, the Board issued a proposed auditing standard entitled *Audit Documentation*, as well as a related amendment to an interim auditing standard (paragraph .12 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*).

The Board received 38 comment letters from a variety of interested parties, including auditors, regulators, professional associations, and government agencies. Those comments led to some changes in the requirements of the standard.

The Board's standard on audit documentation will be one of the fundamental building blocks on which both the integrity of audits and the Board's oversight will rest. The integrity of an audit depends, in large part, on the existence of a complete and understandable record of the work that the auditor performed, the evidence gathered, and the conclusions reached. Meaningful review by managers and partners, or by the Board in the context of its inspections, would be difficult, if not impossible, without adequate documentation. Clear and comprehensive audit documentation is essential for auditors to enhance the quality of the audit and for the Board to fulfill its mandate to inspect registered public accounting firms "to assess the degree of compliance" of those firms with applicable standards and laws.

Appendices 1 and 2 to this release contain, respectively, the text of Auditing Standard No. 3, *Audit Documentation*, and the amendment to AU sec. 543. Appendix A to Auditing Standard No. 3 includes the Board's analysis of the comments received and the Board's responses.

A. Introduction

Auditors document the evidence supporting the conclusions reached in their reports with a work product commonly referred to as *audit documentation* or *working papers*. Sufficient audit documentation is an integral part of a quality audit. That is, the auditor documents not only the nature, timing, and extent of the work performed, but also the professional judgments made by members of the engagement team and others.

In addition to providing the basis for the conclusions in the auditor's report, audit documentation facilitates the planning, performance, and supervision of the engagement and provides the basis for the review of the quality of the work by providing the reviewer with written documentation of the evidence supporting the auditor's significant conclusions.

First and foremost, the objectives of this audit documentation standard are to improve audit quality and to enhance public confidence in the quality of auditing and other engagements. Complete and thorough audit documentation improves the quality of the work performed in many ways. One important example is that quality audit documentation is a record of the actual work performed, which provides assurance that the auditor accomplished the planned objectives. Further, the need to document the procedures performed, the evidence obtained, and the conclusions reached demands a disciplined approach to planning and performing the engagement. Also, audit documentation facilitates the reviews performed by supervisors, managers, partners, and PCAOB inspectors.

Inadequate audit documentation diminishes audit quality on many levels. First, if audit documentation does not exist for a particular procedure or conclusion related to a significant matter, its absence casts doubt as to whether the necessary work was done. If the work was not documented, then it becomes difficult for members of the engagement team, and others, to know what was done, what conclusions were reached, and how those conclusions were reached.

The more significant differences between existing requirements under the interim auditing standards and this new standard on audit documentation, along with the related amendment, are described in the following sections.

B. Auditors Must Document Their Work

As previously mentioned, the principal objective of this standard is to improve the quality of audits and other engagements. In so doing, this standard affirmatively requires that auditors document procedures performed, evidence obtained, and conclusions reached. Likewise, a deficiency in documentation is a departure from the Board's standard. The Board emphasizes that, in the event of a deficiency in documentation, the auditor must be prepared to present persuasive other evidence that the procedures were performed, evidence was obtained, and appropriate conclusions were reached.

If it is questionable whether audit procedures were performed or evidence was obtained, the auditor must determine, and if so demonstrate, that the necessary procedures were performed, sufficient evidence was obtained, and appropriate conclusions were reached with respect to the relevant financial statement assertions. There may be circumstances (for example, a Board inspection) in which the auditor may be required to demonstrate with persuasive other evidence that the procedures were actually performed, the evidence was actually obtained, and appropriate conclusions were actually reached. In this and similar contexts, oral explanation alone does not constitute persuasive other evidence. However, oral evidence may be used to clarify other written evidence.

The failure to prepare adequate documentation is serious. The severity of that failure depends on the factors that determine the nature and extent of the documentation for a particular audit area or auditing procedure. For example, when the risk of material misstatement associated with an assertion is high, the failure to document the procedures, evidence, and conclusions related to that assertion is a very serious violation of PCAOB Standards. Failure to provide adequate documentation could limit an auditor's ability to demonstrate that the work was actually performed.

C. An Experienced Auditor Must Understand the Work

Audits and reviews of issuers' financial statements are now, under the Act, subject to review by PCAOB inspectors. Therefore, the Board determined that a documentation standard that enables a PCAOB inspector to understand the work that was performed is essential. Similar to the U.S. General Accounting Office's documentation standard for government and other audits conducted in accordance with generally accepted government auditing standards,[2] this standard requires audit documentation to contain sufficient information to enable an experienced auditor, having no previous connection with the engagement,

[2] U.S. General Accounting Office, *Government Auditing Standards*, "Field Work Standards for Financial Audits" (2003 Revision), paragraph 4.22.

to understand the work that was performed, the name of the person(s) who performed it, the date it was completed, and the conclusions reached.

This standard also defines an *experienced auditor* as one who has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry.

D. Two Significant Dates Defined in This Standard

To ensure quality and consistency in the preparation and retention of audit documentation, the standard defines two important dates: (1) the report release date and (2) the documentation completion date. The *report release date* is the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements. After the report release date, auditors will have 45 days to assemble a complete and final set of audit documentation. The end of this 45-day period is the *documentation completion date*.

Prior to the report release date, the auditor must have—

- Completed all necessary auditing procedures, including clearing review notes and providing support for all final conclusions, and
- Obtained sufficient evidence to support the representations in the auditor's report.

If the auditor obtains and documents evidence after the report release date, the auditor should refer to the interim auditing standards, AU sec. 390, *Consideration of Omitted Procedures After the Report Date* and AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* for related guidance. Auditors should not discard any previously existing documentation in connection with obtaining and documenting evidence after the report release date.

If procedures are performed subsequent to the report release date, auditors must identify and document any additions to audit documentation as a result of those procedures. This documentation must include the nature of the change, the date of the change, the name of the person who prepared the change, and the reason for the change. Furthermore, audit documentation must not be deleted or discarded after the documentation completion date.

E. Subsequent Changes to Audit Documentation

This standard requires that changes to audit documentation after the documentation completion date be documented without deleting or discarding the original documents. Such documentation must indicate the date the information was added, who added it, and the reason for adding it. The SEC has articulated its position on working papers, as well as the importance of documenting any subsequent changes to the working papers.

> Working papers prepared or collected by auditors in the course of an audit provide the single most important support for their representation regarding compliance with generally accepted auditing standards. They serve as the repository for the competent evidential matter necessary to afford the auditors with a reasonable basis for opining on an issuer's financial position. Transactions or events occurring long after the balance sheet date often require reference to prior working papers, and such working papers may have significant usefulness in future audits. It is therefore imperative that auditors preserve their working papers in a complete and unaltered form.

> Auditors should be encouraged to devise orderly procedures for the proper control over the contents of working papers. Moreover, the Commission recognizes that the necessity for evidential matter to be included in the auditor's working papers varies substantially depending on individual audits. When any alterations or additions are made to the working papers subsequent to the issuance of the auditor's report, however, such alterations or additions should themselves be properly documented and indicate the time and circumstances under which they are made.[3]

F. Documentation Deficiencies

Documentation added to the working papers well after completion of the audit or other engagement is likely to be of a lesser quality than that produced contemporaneously when the procedures were performed. It is very difficult to reconstruct and recall specific activities related to gathering audit evidence months, and perhaps years, after the work was actually performed. The turnover of both firm and company staff can cause difficulty in reconstructing conversations, meetings, data, or other evidence. Also, with the passage of time memories fade. "Research has shown that minutes, hours or days after an experience, memory preserves a relatively detailed record, allowing us to reproduce the past with reasonable if not perfect accuracy. But with the passing of time, the particulars fade and opportunities multiply for interference—generated by later, similar experiences—to blur our recollections."[4]

The Board believes that audit evidence should be documented at the time the procedures are performed and that oral explanation should not be the primary source of evidence. Furthermore, any oral explanation should not contradict the documented evidence, and appropriate consideration should be given to the credibility of the individual providing the oral explanation.

G. Multi-Location Audits

In this standard, the Board reminds auditors that the office of the accounting firm issuing the auditor's report is responsible for ensuring that all audit documentation sufficient to meet the requirements of this standard is prepared and retained. Audit documentation supporting the work performed by other auditors (including auditors associated with other offices of the firm, affiliated firms, or non-affiliated firms), must be retained by or be accessible to the office issuing the auditor's report. The Board believes this requirement will improve audit quality by enhancing the probability that *all* audit documentation will be prepared consistently with the same standards of audit quality.

In addition, the office issuing the auditor's report must obtain and review, prior to the report release date, certain documentation—outlined in this standard—related to the work performed by other auditors. Thus, the firm issuing an audit report on consolidated financial statements of a multinational company may not release that report without the specific documentation described in this standard.

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[3] In the Matter of S.D. Leidesdorf & Co., Kenneth Larsen, Joseph Grendi (*Accounting Series Release No. 209, February 1977*).

[4] Dr. Daniel Schacter, "The Seven Sins of Memory: How the Mind Forgets and Remembers," *Psychology Today* (May 2001).

H. Part of Audit Performed by Others

In reporting on a company's consolidated financial statements, an auditor may use the work of other auditors who have audited one or more affiliates or divisions of the company. When more than one auditor is involved in an audit engagement, one of the firms typically serves as the principal auditor. The principal auditor then must decide whether to make reference in the auditor's report to the audit performed by the other auditor.

If the principal auditor decides to assume responsibility for the work of other auditors, then the principal auditor will not make reference to the work of other auditors in the audit report. However, if the principal auditor decides not to assume that responsibility, then the principal auditor should indicate clearly the division of responsibility between the principal auditor and other auditors in expressing an opinion on the consolidated financial statements. Existing guidance in AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, applies when using the work of other auditors. However, this existing guidance does not establish any specific documentation requirements.

In connection with PCAOB Auditing Standard No. 3, *Audit Documentation*, the Board adopted an amendment to paragraph .12 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, addressing appropriate audit documentation when a principal auditor decides not to make reference to the work of other auditors. In this amendment, the Board imposes the same unconditional responsibility on the principal auditor, as with multi-location audits, to obtain certain audit documentation from the other auditor prior to the report release date. In addition, the amendment provides that the principal auditor should consider performing one or more of the procedures described in the amendment, such as discussing the audit procedures and related results with the other auditors and reviewing the audit programs of the other auditors.

The Board believes this amendment will enable the principal auditor to gain considerably more assurance about the quality of the other auditor's work without creating an unreasonable burden.

I. Retention of Audit Documentation

This standard requires that an auditor retain audit documentation for seven years after the report release date, which is the minimum period permitted under Section 103(a) of the Act.

As previously discussed, auditors will have 45 days after the report release date to assemble the complete and final set of audit documentation. If an auditor's report is not issued on a completed engagement, as is common in a review of interim financial information of a public company, then the audit documentation is to be retained for seven years from the date that fieldwork was substantially completed.

J. Effective Date

On March 9, 2004, the Board issued PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. Since documentation issues are prevalent in PCAOB Auditing Standard No. 2 and the key objective of this standard is to improve the quality of audits and other engagements, the Board determined that the implementation date of this standard should coincide with that of PCAOB Auditing Standard No. 2. Therefore, this standard will be effective for audits of financial statements with respect to fiscal years ending on or after

the later of November 15, 2004, or 30 days after the date of approval of this standard by the SEC.

The effective date for quarterly reviews and other engagements, conducted pursuant to the standards of the PCAOB, would occur beginning with the first quarter ending after the first financial statement audit covered by this standard.

* * * * * *

On the 9th day of June, in the year 2004, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Acting Secretary
June 9, 2004

APPENDICES—

1. Auditing Standard No. 3—*Audit Documentation*
2. Amendment to Interim Auditing Standards—*Part of Audit Performed by Other Independent Auditors*

Appendix 1

Auditing Standard No. 3, *Audit Documentation*

[Supersedes SAS No. 96, *Audit Documentation*]

Introduction

1. This standard establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to the standards of the Public Company Accounting Oversight Board ("PCAOB"). Such engagements include an audit of financial statements, an audit of internal control over financial reporting, and a review of interim financial information. This standard does not replace specific documentation requirements of other standards of the PCAOB.

Objectives of Audit Documentation

2. *Audit documentation* is the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise. Audit documentation also facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Among other things, audit documentation includes records of the planning and performance of the work, the procedures performed, evidence obtained, and conclusions reached by the auditor. Audit documentation also may be referred to as *work papers* or *working papers*.

> Note: An auditor's representations to a company's board of directors or audit committee, stockholders, investors, or other interested parties are usually included in the auditor's report accompanying the financial statements of the company. The auditor also might make oral representations to the company or others, either on a voluntary basis or if necessary to comply with professional standards, including in connection with an engagement for which an auditor's report is not issued. For example, although an auditor might not issue a report in connection with an engagement to review interim financial information, he or she ordinarily would make oral representations about the results of the review.

3. Audit documentation is reviewed by members of the engagement team performing the work and might be reviewed by others. Reviewers might include, for example:

a. Auditors who are new to an engagement and review the prior year's documentation to understand the work performed as an aid in planning and performing the current engagement.

b. Supervisory personnel who review documentation prepared by assistants on the engagement.

c. Engagement supervisors and engagement quality reviewers who review documentation to understand how the engagement team reached significant conclusions and whether there is adequate evidential support for those conclusions.

d. A successor auditor who reviews a predecessor auditor's audit documentation.

e. Internal and external inspection teams that review documentation to assess audit quality and compliance with auditing and related professional practice standards; applicable laws, rules, and regulations; and the auditor's own quality control policies.

f. Others, including advisors engaged by the audit committee or representatives of a party to an acquisition.

Audit Documentation Requirement

4. The auditor must prepare audit documentation in connection with each engagement conducted pursuant to the standards of the PCAOB. Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. Also, the documentation should be appropriately organized to provide a clear link to the significant findings or issues. [1] Examples of audit documentation include memoranda, confirmations, correspondence, schedules, audit programs, and letters of representation. Audit documentation may be in the form of paper, electronic files, or other media.

5. Because audit documentation is the written record that provides the support for the representations in the auditor's report, it should:

a. Demonstrate that the engagement complied with the standards of the PCAOB,

b. Support the basis for the auditor's conclusions concerning every relevant financial statement assertion, and

c. Demonstrate that the underlying accounting records agreed or reconciled with the financial statements.

6. The auditor must document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions. [2] Audit documentation must clearly demonstrate that the work was in fact performed. This documentation requirement applies to the work of all those who participate in the engagement as well as to the work of specialists the auditor uses as evidential matter in evaluating relevant financial statement assertions. Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement:

a. To understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and

b. To determine who performed the work and the date such work was completed as well as the person who reviewed the work and the date of such review.

Note: An *experienced auditor* has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry.

7. In determining the nature and extent of the documentation for a financial statement assertion, the auditor should consider the following factors:

- Nature of the auditing procedure;
- Risk of material misstatement associated with the assertion;

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[1] See paragraph 12 of this standard for a description of significant findings or issues.

[2] *Relevant financial statement assertions* are described in paragraphs 68-70 of PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements*.

- Extent of judgment required in performing the work and evaluating the results, for example, accounting estimates require greater judgment and commensurately more extensive documentation;
- Significance of the evidence obtained to the assertion being tested; and
- Responsibility to document a conclusion not readily determinable from the documentation of the procedures performed or evidence obtained.

Application of these factors determines whether the nature and extent of audit documentation is adequate.

8. In addition to the documentation necessary to support the auditor's final conclusions, audit documentation must include information the auditor has identified relating to significant findings or issues that is inconsistent with or contradicts the auditor's final conclusions. The relevant records to be retained include, but are not limited to, procedures performed in response to the information, and records documenting consultations on, or resolutions of, differences in professional judgment among members of the engagement team or between the engagement team and others consulted.

9. If, after the documentation completion date (defined in paragraph 15), the auditor becomes aware, as a result of a lack of documentation or otherwise, that audit procedures may not have been performed, evidence may not have been obtained, or appropriate conclusions may not have been reached, the auditor must determine, and if so demonstrate, that sufficient procedures were performed, sufficient evidence was obtained, and appropriate conclusions were reached with respect to the relevant financial statement assertions. To accomplish this, the auditor must have persuasive other evidence. Oral explanation alone does not constitute persuasive other evidence, but it may be used to clarify other written evidence.

- If the auditor determines and demonstrates that sufficient procedures were performed, sufficient evidence was obtained, and appropriate conclusions were reached, but that documentation thereof is not adequate, then the auditor should consider what additional documentation is needed. In preparing additional documentation, the auditor should refer to paragraph 16.
- If the auditor cannot determine or demonstrate that sufficient procedures were performed, sufficient evidence was obtained, or appropriate conclusions were reached, the auditor should comply with the provisions of AU sec. 390, *Consideration of Omitted Procedures After the Report Date*.

Documentation of Specific Matters

10. Documentation of auditing procedures that involve the inspection of documents or confirmation, including tests of details, tests of operating effectiveness of controls, and walkthroughs, should include identification of the items inspected. Documentation of auditing procedures related to the inspection of significant contracts or agreements should include abstracts or copies of the documents.

Note: The identification of the items inspected may be satisfied by indicating the source from which the items were selected and the specific selection criteria, for example:

- If an audit sample is selected from a population of documents, the documentation should include identifying characteristics (for example, the specific check numbers of the items included in the sample).
- If all items over a specific dollar amount are selected from a population of documents, the documentation need describe only the scope and the identification of the population (for example, all checks over $10,000 from the October disbursements journal).
- If a systematic sample is selected from a population of documents, the documentation need only provide an identification of the source of the documents and an indication of the starting point and the sampling interval (for example, a systematic sample of sales invoices was selected from the sales journal for the period from October 1 to December 31, starting with invoice number 452 and selecting every 40th invoice).

11. Certain matters, such as auditor independence, staff training and proficiency and client acceptance and retention, may be documented in a central repository for the public accounting firm ("firm") or in the particular office participating in the engagement. If such matters are documented in a central repository, the audit documentation of the engagement should include a reference to the central repository. Documentation of matters specific to a particular engagement should be included in the audit documentation of the pertinent engagement.

12. The auditor must document significant findings or issues, actions taken to address them (including additional evidence obtained), and the basis for the conclusions reached in connection with each engagement. *Significant findings or issues* are substantive matters that are important to the procedures performed, evidence obtained, or conclusions reached, and include, but are not limited to, the following:

a. Significant matters involving the selection, application, and consistency of accounting principles, including related disclosures. Significant matters include, but are not limited to, accounting for complex or unusual transactions, accounting estimates, and uncertainties as well as related management assumptions.

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

c. Audit adjustments. For purposes of this standard, an *audit adjustment* is a correction of a misstatement of the financial statements that was or should have been proposed by the auditor, whether or not recorded by management, that could, either individually or when aggregated with other misstatements, have a material effect on the company's financial statements.

d. Disagreements among members of the engagement team or with others consulted on the engagement about final conclusions reached on significant accounting or auditing matters.

e. Circumstances that cause significant difficulty in applying auditing procedures.

f. Significant changes in the assessed level of audit risk for particular audit areas and the auditor's response to those changes.

g. Any matters that could result in modification of the auditor's report.

13. The auditor must identify all significant findings or issues in an *engagement completion document*. This document may include either all information necessary to understand the significant findings, issues or cross-references, as appropriate, to other available supporting audit documentation. This document, along with any documents cross-referenced, should collectively be as specific as necessary in the circumstances for a reviewer to gain a thorough understanding of the significant findings or issues.

Note: The engagement completion document prepared in connection with the annual audit should include documentation of significant findings or issues identified during the review of interim financial information.

Retention of and Subsequent Changes to Audit Documentation

14. The auditor must retain audit documentation for seven years from the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements (*report release date*), unless a longer period of time is required by law. If a report is not issued in connection with an engagement, then the audit documentation must be retained for seven years from the date that fieldwork was substantially completed. If the auditor was unable to complete the engagement, then the audit documentation must be retained for seven years from the date the engagement ceased.

15. Prior to the report release date, the auditor must have completed all necessary auditing procedures and obtained sufficient evidence to support the representations in the auditor's report. A complete and final set of audit documentation should be assembled for retention as of a date not more than 45 days after the report release date (*documentation completion date*). If a report is not issued in connection with an engagement, then the documentation completion date should not be more than 45 days from the date that fieldwork was substantially completed. If the auditor was unable to complete the engagement, then the documentation completion date should not be more than 45 days from the date the engagement ceased.

16. Circumstances may require additions to audit documentation after the report release date. Audit documentation must not be deleted or discarded after the documentation completion date, however, information may be added. Any documentation added must indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it.

17. Other standards require the auditor to perform procedures subsequent to the report release date in certain circumstances. For example, in accordance with AU sec. 711, *Filings Under Federal Securities Statutes*, auditors are required to perform certain procedures up to the effective date of a registration statement. [3] The auditor must identify and document any additions to audit documentation as a result of these procedures consistent with the previous paragraph.

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[3] Section 11 of the Securities Act of 1933 makes specific mention of the auditor's responsibility as an expert when the auditor's report is included in a registration statement under the 1933 Act.

18. The office of the firm issuing the auditor's report is responsible for ensuring that all audit documentation sufficient to meet the requirements of paragraphs 4–13 of this Standard is prepared and retained. Audit documentation supporting the work performed by other auditors (including auditors associated with other offices of the firm, affiliated firms, or non-affiliated firms), must be retained by or be accessible to the office issuing the auditor's report. [4]

19. In addition, the office issuing the auditor's report must obtain, and review and retain, prior to the report release date, the following documentation related to the work performed by other auditors (including auditors associated with other offices of the firm, affiliated firms, or non-affiliated firms):

a. An engagement completion document consistent with paragraphs 12 and 13.
Note: This engagement completion document should include all cross-referenced, supporting audit documentation.

b. A list of significant fraud risk factors, the auditor's response, and the results of the auditor's related procedures.

c. Sufficient information relating to any significant findings or issues that are inconsistent with or contradict the final conclusions, as described in paragraph 8.

d. Any findings affecting the consolidating or combining of accounts in the consolidated financial statements.

e. Sufficient information to enable the office issuing the auditor's report to agree or to reconcile the financial statement amounts audited by the other auditor to the information underlying the consolidated financial statements.

f. A schedule of audit adjustments, including a description of the nature and cause of each misstatement.

g. All significant deficiencies and material weaknesses in internal control over financial reporting, including a clear distinction between those two categories.

h. Letters of representations from management.

i. All matters to be communicated to the audit committee.

If the auditor decides to make reference in his or her report to the audit of the other auditor, however, the auditor issuing the report need not perform the procedures in this paragraph and, instead, should refer to AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

20. The auditor also might be required to maintain documentation in addition to that required by this standard. [5]

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[4] Section 106(b) of the Sarbanes-Oxley Act of 2002 imposes certain requirements concerning production of the work papers of a foreign public accounting firm on whose opinion or services the auditor relies. Compliance with this standard does not substitute for compliance with Section 106(b) or any other applicable law.

[5] For example, the SEC requires auditors to retain, in addition to documentation required by this standard, memoranda, correspondence, communications (for example, electronic mail), other documents, and records (in the form of paper, electronic, or other media) that are created, sent, or received in connection with an engagement conducted in accordance with auditing and related professional practice standards and that contain conclusions, opinions, analyses, or data related to the engagement. (*Retention of Audit and Review Records*, 17 CFR §210.2-06, effective for audits or reviews completed on or after October 31, 2003.)

Effective Date

21. This standard is effective for audits of financial statements, which may include an audit of internal control over financial reporting, with respect to fiscal years ending on or after November 15, 2004. For other engagements conducted pursuant to the standards of the PCAOB, including reviews of interim financial information, this standard takes effect beginning with the first quarter ending after the first financial statement audit covered by this standard.

Appendix A

Background and Basis for Conclusions

Introduction

A1. This appendix summarizes considerations that the Public Company Accounting Oversight Board ("PCAOB" or "Board") deemed significant in developing this standard. This Appendix includes reasons for accepting certain views and rejecting others.

A2. Section 103(a)(2)(A)(i) of the Sarbanes-Oxley Act of 2002 (the "Act") directs the Board to establish auditing standards that require registered public accounting firms to prepare and maintain, for at least seven years, audit documentation "in sufficient detail to support the conclusions reached" in the auditor's report. Accordingly, the Board has made audit documentation a priority.

Background

A3. Auditors support the conclusions in their reports with a work product called *audit documentation*, also referred to as *working papers* or *work papers*. Audit documentation supports the basis for the conclusions in the auditor's report. Audit documentation also facilitates the planning, performance, and supervision of the engagement and provides the basis for the review of the quality of the work by providing the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Examples of audit documentation include memoranda, confirmations, correspondence, schedules, audit programs, and letters of representation. Audit documentation may be in the form of paper, electronic files, or other media.

A4. The Board's standard on audit documentation is one of the fundamental building blocks on which both the integrity of audits and the Board's oversight will rest. The Board believes that the quality and integrity of an audit depends, in large part, on the existence of a complete and understandable record of the work the auditor performed, the conclusions the auditor reached, and the evidence the auditor obtained that supports those conclusions. Meaningful reviews, whether by the Board in the context of its inspections or through other reviews, such as internal quality control reviews, would be difficult or impossible without adequate documentation. Clear and comprehensive audit documentation is essential to enhance the quality of the audit and, at the same time, to allow the Board to fulfill its mandate to inspect registered public accounting firms to assess the degree of compliance of those firms with applicable standards and laws.

A5. The Board began a standards-development project on audit documentation by convening a public roundtable discussion on September 29, 2003, to discuss issues and hear views on the subject. Participants at the roundtable included representatives from public companies, public accounting firms, investor groups, and regulatory organizations.

A6. Prior to this roundtable discussion, the Board prepared and released a briefing paper on audit documentation that posed several questions to help identify the objectives—and the appropriate scope and form—of audit documentation. In addition, the Board asked participants to address specific issues in practice relating to, among other things, changes in audit documentation after release of the audit report, essential elements and the appropriate amount of detail of audit documentation, the effect on audit documentation of a principal auditor's

decision to use the work of other auditors, and retention of audit documentation. Based on comments made at the roundtable, advice from the Board's staff, and other input the Board received, the Board determined that the pre-existing standard on audit documentation, Statement on Auditing Standards ("SAS") No. 96, *Audit Documentation*, was insufficient for the Board to discharge appropriately its standard-setting obligations under Section 103(a) of the Act. In response, the Board developed and issued for comment, on November 17, 2003, a proposed auditing standard titled, *Audit Documentation*.

A7. The Board received 38 comment letters from a variety of interested parties, including auditors, regulators, professional associations, government agencies, and others. Those comments led to some changes in the requirements of the standard. Also, other changes made the requirements easier to understand. The following sections summarize significant views expressed in those comment letters and the Board's responses to those comments.

Objective of This Standard

A8. The objective of this standard is to improve audit quality and enhance public confidence in the quality of auditing. Good audit documentation improves the quality of the work performed in many ways, including, for example:

- Providing a record of actual work performed, which provides assurance that the auditor accomplishes the planned objectives.
- Facilitating the reviews performed by supervisors, managers, engagement partners, engagement quality reviewers,[1] and PCAOB inspectors.
- Improving effectiveness and efficiency by reducing time-consuming, and sometimes inaccurate, oral explanations of what was done (or not done).

A9. The documentation requirements in this standard should result in more effective and efficient oversight of registered public accounting firms and associated persons, thereby improving audit quality and enhancing investor confidence.

A10. Inadequate audit documentation diminishes audit quality on many levels. First, if audit documentation does not exist for a particular procedure or conclusion related to a significant matter, it casts doubt as to whether the necessary work was done. If the work was not documented, then it becomes difficult for the engagement team, and others, to know what was done, what conclusions were reached, and how those conclusions were reached. In addition, good audit documentation is very important in an environment in which engagement staff changes or rotates. Due to engagement staff turnover, knowledgeable staff on an engagement may not be available for the next engagement.

Audit Programs

A11. Several commenters suggested that audit documentation should include audit programs. Audit programs were specifically mentioned in SAS No. 96 as a form of audit documentation.

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[1] The engagement quality reviewer is referred to as the concurring partner reviewer in the membership requirements of the AICPA SEC Practice Section. The Board adopted certain of these membership requirements as they existed on April 16, 2003. Some firms also may refer to this designated reviewer as the second partner reviewer.

A12. The Board accepted this recommendation, and paragraph 4 in the final Standard includes audit programs as an example of documentation. Audit programs may provide evidence of audit planning as well as limited evidence of the execution of audit procedures, but the Board believes that signed-off audit programs should generally not be used as the sole documentation that a procedure was performed, evidence was obtained, or a conclusion was reached. An audit program aids in the conduct and supervision of an engagement, but completed and initialed audit program steps should be supported with proper documentation in the working papers.

Reviewability Standard

A13. The proposed standard would have adapted a standard of reviewability from the U.S. General Accounting Office's ("GAO") documentation standard for government and other audits conducted in accordance with generally accepted government auditing standards ("GAGAS"). The GAO standard provides that "Audit documentation related to planning, conducting, and reporting on the audit should contain sufficient information to enable an experienced auditor who has had no previous connection with the audit to ascertain from the audit documentation the evidence that supports the auditors' significant judgments and conclusions."[2] This requirement has been important in the field of government auditing because government audits have long been reviewed by GAO auditors who, although experienced in auditing, do not participate in the actual audits. Moreover, the Panel on Audit Effectiveness recommended that sufficient, specific requirements for audit documentation be established to enable public accounting firms' internal inspection teams as well as others, including reviewers outside of the firms, to assess the quality of engagement performance.[3] Audits and reviews of issuers' financial statements will now, under the Act, be subject to review by PCAOB inspectors. Therefore, a documentation standard that enables an inspector to understand the work that was performed in an audit or review is appropriate.

A14. Accordingly, the Board's proposed standard would have required that audit documentation contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the work that was performed, the name of the person(s) who performed it, the date it was completed, and the conclusions reached. This experienced auditor also should have been able to determine who reviewed the work and the date of such review.

A15. Some commenters suggested that the final standard more specifically describe the qualifications of an experienced auditor. These commenters took the position that only an engagement partner with significant years of experience would have the experience necessary to be able to understand all the work that was performed and the conclusions that were reached. One commenter suggested that an auditor who is reviewing audit documentation should have experience and knowledge consistent with the experience and knowledge that the auditor performing the audit would be required to possess, including knowledge of the current accounting, auditing, and financial reporting issues of the company's industry. Another said that the characteristics defining an experienced auditor should be consistent with those expected of the auditor with final responsibility for the engagement.

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[2] U.S. General Accounting Office, *Government Auditing Standards*, "Field Work Standards for Financial Audits" (2003 Revision), paragraph 4.22.

[3] Panel on Audit Effectiveness, *Report and Recommendations* (Stamford, Ct: Public Oversight Board, August 31, 2000).

A16. After considering these comments, the Board has provided additional specificity about the meaning of the term, *experienced auditor*. The standard now describes an experienced auditor as one who has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry.

A17. Some commenters also suggested that the standard, as proposed, did not allow for the use of professional judgment. These commenters pointed to the omission of a statement about professional judgment found in paragraph 4.23 of GAGAS that states, "The quantity, type, and content of audit documentation are a matter of the auditors' professional judgment." A nearly identical statement was found in the interim auditing standard, SAS No. 96, *Audit Documentation*.

A18. Auditors exercise professional judgment in nearly every aspect of planning, performing, and reporting on an audit. Auditors also exercise professional judgment in the documentation of an audit and other engagements. An objective of this standard is to ensure that auditors give proper consideration to the need to document procedures performed, evidence obtained, and conclusions reached in light of time and cost considerations in completing an engagement.

A19. Nothing in the standard precludes auditors from exercising their professional judgment. Moreover, because professional judgment might relate to any aspect of an audit, the Board does not believe that an explicit reference to professional judgment is necessary every time the use of professional judgment may be appropriate.

Audit Documentation Must Demonstrate That the Work Was Done

A20. A guiding principle of the proposed standard was that auditors must document procedures performed, evidence obtained, and conclusions reached. This principle is not new and was found in the interim standard, SAS No. 96, *Audit Documentation*, which this standard supersedes. Audit documentation also should demonstrate compliance with the standards of the PCAOB and include justification for any departures.

A21. The proposed standard would have adapted a provision in the California Business and Professions Code which provides that if documentation does not exist, then there is a rebuttable presumption that the work had not been done.

A22. The objections to this proposal fell into two general categories: the effect of the rebuttable presumption on legal proceedings and the perceived impracticality of documenting every conversation or conclusion that affected the engagement. Discussion of these issues follows.

Rebuttable Presumption

A23. Commenters expressed concern about the effects of the proposed language on regulatory or legal proceedings outside the context of the PCAOB's oversight. They argued that the rebuttable presumption might be understood to establish evidentiary rules for use in judicial and administrative proceedings in other jurisdictions.

A24. Some commenters also had concerns that oral explanation alone would not constitute persuasive other evidence that work was done, absent any documentation. Those commenters argued that not allowing oral explanations when there was no documentation would essentially make the presumption "irrebuttable." Moreover, those commenters argued that it was inappropriate for a professional standard to predetermine for a court the relative value of evidence.

A25. The Board believes that complete audit documentation is necessary for a quality audit or other engagement. The Board intends the standard to require

auditors to document procedures performed, evidence obtained, and conclusions reached to improve the quality of audits. The Board also intends that a deficiency in documentation is a departure from the Board's standards. Thus, although the Board removed the phrase *rebuttable presumption*, the Board continues to stress, in paragraph 9 of the Standard, that the auditor must have persuasive other evidence that the procedures were performed, evidence was obtained, and appropriate conclusions were reached with respect to relevant financial statement assertions.

A26. The term *should* (presumptively mandatory responsibility) was changed to *must* (unconditional responsibility) in paragraph 6 to establish a higher threshold for the auditor. Auditors have an unconditional requirement to document their work. Failure to discharge an unconditional responsibility is a violation of the standard and Rule 3100, which requires all registered public accounting firms to adhere to the Board's auditing and related professional practice standards in connection with an audit or review of an issuer's financial statements.

A27. The Board also added two new paragraphs to the final standard to explain the importance and associated responsibility of performing the work and adequately documenting all work that was performed. Paragraph 7 provides a list of factors the auditor should consider in determining the nature and extent of documentation. These factors should be considered by both the auditor in preparing the documentation and the reviewer in evaluating the documentation.

A28. In paragraph 9 of this Standard, if, after the documentation completion date, as a result of a lack of documentation or otherwise, it appears that audit procedures may not have been performed, evidence may not have been obtained, or appropriate conclusions may not have been reached, the auditor must determine, and if so demonstrate, that sufficient procedures were performed, sufficient evidence was obtained, and appropriate conclusions were reached with respect to the relevant financial statement assertions. In those circumstances, for example, during an inspection by the Board or during the firm's internal quality control review, the auditor is required to demonstrate with persuasive other evidence that the procedures were performed, the evidence was obtained, and appropriate conclusions were reached. In this and similar contexts, oral explanation alone does not constitute persuasive other evidence. However, oral evidence may be used to clarify other written evidence.

A29. In addition, more reliable, objective evidence may be required depending on the nature of the test and the objective the auditor is trying to achieve. For example, if there is a high risk of a material misstatement with respect to a particular assertion, then the auditor should obtain and document sufficient procedures for the auditor to conclude on the fairness of the assertion.

Impracticality

A30. Some commenters expressed concern that the proposed standard could be construed or interpreted to require the auditor to document every conversation held with company management or among the engagement team members. Some commenters also argued that they should not be required to document every conclusion, including preliminary conclusions that were part of a thought process that may have led them to a different conclusion, on the ground that this would result in needless and costly work performed by the auditor. Commenters also expressed concern that an unqualified requirement to document procedures performed, evidence obtained, and conclusions reached without allowing the use of auditor judgment would increase the volume of documentation

but not the quality. They stated that it would be unnecessary, time-consuming, and potentially counterproductive to require the auditor to make a written record of everything he or she did.

A31. The Board's standard distinguishes between (1) an audit procedure that must be documented and (2) a conversation with company management or among the members of the engagement team. Inquiries with management should be documented when an inquiry is important to a particular procedure. The inquiry could take place during planning, performance, or reporting. The auditor need not document each conversation that occurred.

A32. A final conclusion is an integral part of a working paper, unless the working paper is only for informational purposes, such as documentation of a discussion or a process. This standard does not require that the auditor document each interim conclusion reached in arriving at the risk assessments or final conclusions. Conclusions reached early on during an audit may be based on incomplete information or an incorrect understanding. Nevertheless, auditors should document a final conclusion for every audit procedure performed, if that conclusion is not readily apparent based on documented results of the procedures.

A33. The Board also believes the reference to *specialists* is an important element of paragraph 6. Specialists play a vital role in audit engagements. For example, appraisers, actuaries, and environmental consultants provide valuable data concerning asset values, calculation assumptions, and loss reserves. When using the work of a specialist, the auditor must ensure that the specialist's work, as it relates to the audit objectives, also is adequately documented. For example, if the auditor relies on the work of an appraiser in obtaining the fair value of commercial property available for sale, then the auditor must ensure the appraisal report is adequately documented. Moreover, the term *specialist* in this standard is intended to include any specialist the auditor relies on in conducting the work, including those employed or retained by the auditor or by the company.

Audit Adjustments

A34. Several commenters recommended that the definition of *audit adjustments* in this proposed standard should be consistent with the definition contained in AU sec. 380, *Communication With Audit Committees*.

A35. Although the Board recognizes potential benefits of having a uniform definition of the term *audit adjustments*, the Board does not believe that the definition in AU sec. 380 is appropriate for this documentation standard because that definition was intended for communication with audit committees. The Board believes that the definition should be broader so that the engagement partner, engagement quality reviewer, and others can be aware of all proposed corrections of misstatements, whether or not recorded by the entity, of which the auditor is aware, that were or should have been proposed based on the audit evidence.

A36. Adjustments that should have been proposed based on known audit evidence are material misstatements that the auditor identified but did not propose to management. Examples include situations in which (1) the auditor identifies a material error but does not propose an adjustment and (2) the auditor proposes an adjustment in the working papers, but fails to note the adjustment in the summary or schedule of proposed adjustments.

Information That Is Inconsistent With or Contradicts the Auditor's Final Conclusions

A37. Paragraph .25 of AU sec. 326, *Evidential Matter*, states: "In developing his or her opinion, the auditor should consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements." Thus, during the conduct of an audit, the auditor should consider all relevant evidential matter even though it might contradict or be inconsistent with other conclusions. Audit documentation must contain information or data relating to significant findings or issues that are inconsistent with the auditor's final conclusions on the relevant matter.

A38. Also, information that initially appears to be inconsistent or contradictory, but is found to be incorrect or based on incomplete information, need not be included in the final audit documentation, provided that the apparent inconsistencies or contradictions were satisfactorily resolved by obtaining complete and correct information. In addition, with respect to differences in professional judgment, auditors need not include in audit documentation preliminary views based on incomplete information or data.

Retention of Audit Documentation

A39. The proposed standard would have required an auditor to retain audit documentation for seven years after completion of the engagement, which is the minimum period permitted under Section 103(a)(2)(A)(i) of the Act. In addition, the proposed standard would have added a new requirement that the audit documentation must be assembled for retention within a reasonable period of time after the auditor's report is released. Such reasonable period of time should not exceed 45 days.

A40. In general, those commenting on this documentation retention requirement did not have concerns with the time period of 45 days to assemble the working papers. However, some commenters suggested the Board tie this 45-day requirement to the filing date of the company's financial statements with the SEC. One commenter recommended that the standard refer to the same trigger date for initiating both the time period during which the auditor should complete work paper assembly and the beginning of the seven-year retention period.

A41. For consistency and practical implications, the Board agreed that the standard should have the same date for the auditor to start assembling the audit documentation and initiating the seven-year retention period. The Board decided that the seven-year retention period begins on the *report release date*, which is defined as the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements. In addition, auditors will have 45 days to assemble the complete and final set of audit documentation, beginning on the report release date. The Board believes that using the report release date is preferable to using the filing date of the company's financial statements, since the auditor has ultimate control over granting permission to use his or her report. If an auditor's report is not issued, then the audit documentation is to be retained for seven years from the date that fieldwork was substantially completed. If the auditor was unable to complete the engagement, then the seven-year period begins when the work on the engagement ceased.

Section 802 of Sarbanes-Oxley and the SEC's Implementing Rule

A42. Many commenters had concerns about the similarity in language between the proposed standard and the SEC final rule (issued in January 2003) on record retention, *Retention of Records Relevant to Audits and Reviews*.[4] Some commenters recommended that the PCAOB undertake a project to identify and resolve all differences between the proposed standard and the SEC's final rule. These commenters also suggested that the Board include similar language from the SEC final rule, Rule 2-06 of Regulation S-X, which limits the requirement to retain some items.

Differences Between Section 802 and This Standard

A43. The objective of the Board's standard is different from the objective of the SEC's rule on record retention. The objective of the Board's standard is to require auditors to create certain documentation to enhance the quality of audit documentation, thereby improving the quality of audits and other related engagements. The records retention section of this standard, mandated by Section 103 of the Act, requires registered public accounting firms to "prepare and maintain for a period of not less than 7 years, *audit work papers, and other information related to any audit report*, in sufficient detail to support the conclusions reached in such report." (emphasis added)

A44. In contrast, the focus of the SEC rule is to require auditors to *retain* documents that the auditor does create, in order that those documents will be available in the event of a regulatory investigation or other proceeding. As stated in the release accompanying the SEC's final rule (SEC Release No. 33-8180):

> Section 802 of the Sarbanes-Oxley Act is intended to address the destruction or fabrication of evidence and the preservation of "financial and audit records." We are directed under that section to promulgate rules related to the retention of records relevant to the audits and reviews of financial statements that companies file with the Commission.

A45. The SEC release further states, "New rule 2-06...addresses the retention of documents relevant to enforcement of the securities laws, Commission rules, and criminal laws."

A46. Despite their different objectives, the proposed standard and SEC Rule 2-06 use similar language in describing documentation generated during an audit or review. Paragraph 4 of the proposed Standard stated that, "Audit documentation ordinarily consists of *memoranda, correspondence*, schedules, and *other documents created* or obtained *in connection with* the engagement and may be in the form of paper, electronic files, or other media." Paragraph (a) of SEC Rule 2-06 describes "records relevant to the audit or review" that must be retained as, (1) "workpapers and other documents that form the basis of the audit or review and (2) *memoranda, correspondence*, communications, *other documents*, and records (including electronic records), which: [a]re *created*, sent or received *in connection with* the audit or review and [c]ontain conclusions, opinions, analyses, or financial data related to the audit or review. ..." (numbering and emphasis added).

A47. The SEC makes a distinction between the objectives of categories (1) and (2). Category (1) includes audit documentation. Documentation to be retained

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[4] SEC Regulation S-X, 17 C.F.R. § 210.2-06 (SEC Release No. 33-8180, January 2003). (The final rule was effective in March 2003.)

according to the Board's Standard clearly falls within category (1). Items in category (2) include "desk files" which are more than "what traditionally has been thought of as auditor's 'workpapers'." The SEC's rule requiring auditors to retain items in category (2) have the principal purpose of facilitating enforcement of securities laws, SEC rules, and criminal laws. This is not an objective of the Board's Standard. According to SEC Rule 2-06, items in category (2) are limited to those which: (*a*) are created, sent or received in connection with the audit or review, and (*b*) contain conclusions, opinions, analyses, or financial data related to the audit or review. The limitations, (*a*) and (*b*), do not apply to category (1).

A48. Paragraph 4 of the final Standard deletes the reference in the proposed standard to "other documents created or obtained in connection with the engagement." The Board decided to keep "correspondence" in the standard because correspondence can be valid audit evidence. Paragraph 20 of the Standard reminds the auditor that he or she may be required to maintain documentation in addition to that required by this Standard.

Significant Matters and Significant Findings or Issues

A49. Some commenters asked how the term *significant matters*, in Rule 2-06, relates to the term *significant findings* or issues in the Board's Standard. The SEC's release accompanying its final Rule 2-06 states that "...*significant matters* is intended to refer to the documentation of substantive matters that are important to the audit or review process or to the financial statements of the issuer...." This is very similar to the term *significant findings or issues* contained in paragraph 12 of the Board's Standard which requires auditors to document *significant findings or issues*, actions taken to address them (including additional evidence obtained), and the basis for the conclusions reached. Examples of significant findings or issues are provided in the Standard.

A50. Based on the explanation in the SEC's final rule and accompanying release, the Board believes that *significant matters* are included in the meaning of *significant findings or issues* in the Board's standard. The Board is of the view that *significant findings or issues* is more comprehensive and provides more clarity than *significant matters* and, therefore, has not changed the wording in the final Standard.

Changes to Audit Documentation

A51. The proposed standard would have required that any changes to the working papers after completion of the engagement be documented without deleting or discarding the original documents. Such documentation must indicate the date the information was added, by whom it was added, and the reason for adding it.

A52. One commenter recommended that the Board provide examples of auditing procedures that should be performed before the report release date and procedures that may be performed after the report release date. Some commenters also requested clarification about the treatment of changes to documentation that occurred after the completion of the engagement but before the report release date. Many commenters recommended that the Board more specifically describe post-issuance procedures. The Board generally agreed with these comments.

A53. The final Standard includes two important dates for the preparation of audit documentation: (1) the report release date and (2) the documentation completion date.

- Prior to the report release date, the auditor must have completed all necessary auditing procedures, including clearing review notes

and providing support for all final conclusions. In addition, the auditor must have obtained sufficient evidence to support the representations in the auditor's reports before the report release date.

- After the report release date and prior to the documentation completion date, the auditor has 45 calendar days in which to assemble the documentation.

A54. During the audit, audit documentation may be superseded for various reasons. Often, during the review process, reviewers annotate the documentation with clarifications, questions, and edits. The completion process often involves revising the documentation electronically and generating a new copy. The SEC's final rule on record retention, *Retention of Records Relevant to Audits and Reviews*,[5] explains that the SEC rule does not require that the following documents generally need to be retained: superseded drafts of memoranda, financial statements or regulatory filings; notes on superseded drafts of memoranda, financial statements or regulatory filings that reflect incomplete or preliminary thinking; previous copies of workpapers that have been corrected for typographical errors or errors due to training of new employees; and duplicates of documents. This standard also does not require auditors to retain such documents as a general matter.

A55. Any documents, however, that reflect information that is either inconsistent with or contradictory to the conclusions contained in the final working papers may not be discarded. Any documents added must indicate the date they were added, the name of the person who prepared them, and the reason for adding them.

A56. If the auditor obtains and documents evidence after the report release date, the auditor should refer to the Interim Auditing Standards, AU sec. 390, *Consideration of Omitted Procedures After the Report Date* and AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. Auditors should not discard any previously existing documentation in connection with obtaining and documenting evidence after the report release date.

A57. The auditor may perform certain procedures subsequent to the report release date. For example, pursuant to AU sec. 711, *Filings Under Federal Securities Statutes*, auditors are required to perform certain procedures up to the effective date of a registration statement. The auditor should identify and document any additions to audit documentation as a result of these procedures. No audit documentation should be discarded after the documentation completion date, even if it is superseded in connection with any procedures performed, including those performed pursuant to AU sec. 711.

A58. Additions to the working papers may take the form of memoranda that explain the work performed, evidence obtained, and conclusions reached. Documentation added to the working papers must indicate the date the information was added, the name of the person adding it, and the reason for adding it. All previous working papers must remain intact and not be discarded.

A59. Documentation added to the working papers well after completion of the audit or other engagement is likely to be of a lesser quality than that produced contemporaneously when the procedures were performed. It is very difficult to reconstruct activities months, and perhaps years, after the work was actually performed. The turnover of both firm and company staff can cause difficulty in reconstructing conversations, meetings, data, or other evidence. Also, with

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[5] See footnote 4.

the passage of time memories fade. Oral explanation can help confirm that procedures were performed during an audit, but oral explanation alone does not constitute persuasive other evidence. The primary source of evidence should be documented at the time the procedures are performed, and oral explanation should not be the primary source of evidence. Furthermore, any oral explanation should not contradict the documented evidence, and appropriate consideration should be given to the credibility of the individual providing the oral explanation.

Multi-Location Audits and Using the Work of Other Auditors

A60. The proposed Standard would have required the principal auditor to maintain specific audit documentation when he or she decided not to make reference to the work of another auditor.

A61. The Board also proposed an amendment to AU sec. 543 concurrently with the proposed audit documentation standard. The proposed amendment would have required the principal auditor to review the documentation of the other auditor to the same extent and in the same manner that the audit work of all those who participated in the engagement is reviewed.

A62. Commenters expressed concerns that these proposals could present conflicts with certain non-U.S. laws. Those commenters also expressed concern about the costs associated with the requirement for the other auditor to ship their audit documentation to the principal auditor. In addition, the commenters also objected to the requirement that principal auditors review the work of other auditors as if they were the principal auditor's staff.

Audit Documentation Must Be Accessible to the Office Issuing the Auditor's Report

A63. After considering these comments, the Board decided that it could achieve one of the objectives of the proposed standard (that is, to require that the issuing office have access to those working papers on which it placed reliance) without requiring that the working papers be shipped to the issuing office. Further, given the potential difficulties of shipping audit documentation from various non-U.S. locations, the Board decided to modify the proposed standard to require that audit documentation either be retained by or be accessible to the issuing office.

A64. In addition, instead of requiring that all of the working papers be shipped to the issuing office, the Board decided to require that the issuing office obtain, review, and retain certain summary documentation. Thus, the public accounting firm issuing an audit report on consolidated financial statements of a multinational company may not release that report without the documentation described in paragraph 19 of the Standard.

A65. The auditor must obtain and review and retain, prior to the report release date, documentation described in paragraph 19 of the Standard, in connection with work performed by other offices of the public accounting firm or other auditors, including affiliated or non-affiliated firms, that participated in the audit. For example, an auditor that uses the work of another of its offices or other affiliated or non-affiliated public accounting firms to audit a subsidiary that is material to a company's consolidated financial statements must obtain the documentation described in paragraph 19 of the Standard, prior to the report release date. On the other hand, an auditor that uses the work of another of its offices or other affiliated or non-affiliated firms, to perform selected procedures, such as observing the physical inventories of a company, may not be required to obtain the documentation specified in paragraph 19 of the Standard. However,

this does not reduce the need for the auditor to obtain equivalent documentation prepared by the other auditor when those instances described in paragraph 19 of the Standard are applicable.

Amendment to AU Sec. 543, Part of Audit Performed by Other Independent Auditors

A66. Some commenters also objected to the proposed requirement in the amendment to AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, that the principal auditor review another auditor's audit documentation. They objected because they were of the opinion such a review would impose an unnecessary cost and burden given that the other auditor will have already reviewed the documentation in accordance with the standards established by the principal auditor. The commenters also indicated that any review by the principal auditor would add excessive time to the SEC reporting process, causing even more difficulties as the SEC Form 10-K reporting deadlines have become shorter recently and will continue to shorten next year.

A67. The Board accepted the recommendation to modify the proposed amendment to AU sec. 543, *Part of Audit Performed by Other Independent Auditors*. Thus, in the final amendment, the Board imposes the same unconditional responsibility on the principal auditor to obtain certain audit documentation from the other auditor prior to the report release date. The final amendment also provides that the principal auditor should consider performing one or more of the following procedures:

- Visit the other auditors and discuss the audit procedures followed and results thereof.
- Review the audit programs of the other auditors. In some cases, it may be appropriate to issue instructions to the other auditors as to the scope of the audit work.
- Review additional audit documentation of the other auditors relating to significant findings or issues in the engagement completion document.

Effective Date

A68. The Board proposed that the Standard and related amendment would be effective for engagements completed on or after June 15, 2004. Many commenters were concerned that the effective date was too early. They pointed out that some audits, already begun as of the proposed effective date, would be affected and that it could be difficult to retroactively apply the Standard. Some commenters also recommended delaying the effective date to give auditors adequate time to develop and implement processes and provide training with respect to several aspects of the Standard.

A69. After considering the comments, the Board has delayed the effective date. However, the Board also believes that a delay beyond 2004 is not in the public interest.

A70. The Board concluded that the implementation date of this Standard should coincide with that of PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, because of the documentation issues prevalent in PCAOB Auditing Standard No. 2. Therefore, the Board has decided that the standard will be effective for audits of financial statements with respect to fiscal years ending on or after November 15, 2004. The effective date for reviews of interim financial information and other engagements, conducted pursuant to the

Standards of the PCAOB, would occur beginning with the first quarter ending after the first financial statement audit covered by this Standard.

Reference to Audit Documentation As the Property of the Auditor

A71. Several commenters noted that SAS No. 96, *Audit Documentation*, the interim auditing standard on audit documentation, referred to audit documentation as the property of the auditor. This was not included in the proposed Standard because the Board did not believe ascribing property rights would have furthered this standard's purpose to enhance the quality of audit documentation.

Confidential Client Information

A72. SAS No. 96, *Audit Documentation*, also stated that, "the auditor has an ethical, and in some situations a legal, obligation to maintain the confidentiality of client information," and referenced Rule 301, *Confidential Client Information*, of the AICPA's Code of Professional Conduct. Again, the Board's proposed standard on audit documentation did not include this provision. In adopting certain interim Standards and rules as of April 16, 2003, the Board did not adopt Rule 301 of the AICPA's Code of Professional Conduct. In this Standard on audit documentation, the Board seeks neither to establish confidentiality standards nor to modify or detract from any existing applicable confidentiality requirements.

Addendum

Additional Documentation Requirements of SEC Rule 2-06

This addendum is not a part of PCAOB Auditing Standard No. 3.

B1. Auditors should be aware of the additional record retention requirements in SEC Rule 2-06 of Regulation S-X ("Rule 2-06"). The Board is providing additional information below to remind auditors of the SEC requirements. This addendum is not an interpretation of Rule 2-06. Instead, this addendum provides excerpts from the SEC release accompanying the final rule which provides the SEC's interpretation of the rule's requirements, particularly paragraphs (a) and (c) of Rule 2-06.

B2. Paragraph (a) of Rule 2-06 requires that:

> . . . the accountant shall retain . . . memoranda, correspondence, communications, other documents, and records (including electronic records) which:
>
> (1) Are created, sent or received in connection with the audit or review, and
>
> (2) Contain conclusions, opinions, analyses, or financial data related to the audit or review.

B3. Paragraph (c) of Rule 2-06 states:

> Memoranda, correspondence, communications, other documents, and records (including electronic records) described in paragraph (a) of this section shall be retained whether they support the auditor's final conclusions regarding the audit or review, or contain information or data relating to a significant matter, that is inconsistent with the auditor's final conclusions regarding that matter or the audit or review. Significance of a matter shall be determined based on an objective analysis of the facts and circumstances. Such documents and records include, but are not limited to, those documenting a consultation on or resolution of differences in professional judgment.

Other Statements by the SEC

B4. In the excerpt below, from the SEC's release accompanying its final Rule 2-06, the SEC discusses documents that generally are not required to be retained under Rule 2-06.

> In the Proposing Release, we stated that non-substantive materials that are not part of the workpapers, such as administrative records, and other documents that do not contain relevant financial data or the auditor's conclusions, opinions or analyses would not meet the second of the criteria in Rule 2-06(a) and would not have to be retained. Commentators questioned whether the following documents would be considered substantive and have to be retained:
>
> - Superseded drafts of memoranda, financial statements or regulatory filings,
> - Notes on superseded drafts of memoranda, financial statements or regulatory filings that reflect incomplete or preliminary thinking,
> - Previous copies of workpapers that have been corrected for typographical errors or errors due to training of new employees,

- Duplicates of documents, or
- Voice-mail messages.

These records generally would not fall within the scope of new Rule 2-06 provided they do not contain information or data, relating to a significant matter that is inconsistent with the auditor's final conclusions, opinions or analyses on that matter or the audit or review. For example, Rule 2-06 would require the retention of an item in this list if that item documented a consultation or resolution of differences of professional judgment.

B5. The excerpt below, from the SEC's release accompanying its final Rule 2-06, provides further explanation about documents to be retained under Rule 2-06:

> In consideration of the comments received, we have revised paragraph (c) of the rule. We have removed the phrase "cast doubt" to reduce the possibility that the rule mistakenly would be interpreted to reach typographical errors, trivial or "fleeting" matters, or errors due to "on-the-job" training. We continue to believe, however, that records that either support or contain significant information that is inconsistent with the auditor's final conclusions would be relevant to an investigation of possible violations of the securities laws, Commission rules, or criminal laws and should be retained. Paragraph (c), therefore, now provides that the materials described in paragraph (a) shall be retained whether they support the auditor's final conclusions or contain information or data, relating to a significant matter that is inconsistent with the final conclusions of the auditor on that matter or on the audit or review. Paragraph (c) also states that the documents and records to be retained include, but are not limited to, those documenting consultations on or resolutions of differences in professional judgment.
>
> The reference in paragraph (c) to "significant" matters is intended to refer to the documentation of substantive matters that are important to the audit or review process or to the financial statements of the issuer or registered investment company. Rule 2-06(c) requires that the documentation of such matters, once prepared, must be retained even if it does not "support" the auditor's final conclusions, because it may be relevant to an investigation. Similarly, the retention of records regarding a consultation about, and resolution of, differences in professional judgment would be relevant to such an investigation and must be retained. We intend for Rule 2-06 to be incremental to, and not to supersede or otherwise affect, any other legal or procedural requirement related to the retention of records or potential evidence in a legal, administrative, disciplinary, or regulatory proceeding.
>
> Finally, we recognize that audits and reviews of financial statements are interactive processes and views within an accounting firm on accounting, auditing or disclosure issues may evolve as new information or data comes to light during the audit or review. We do not view "differences in professional judgment" within subparagraph (c) to include such changes in preliminary views when those preliminary views are based on what is recognized to be incomplete information or data.

Appendix 2

Amendment to Interim Auditing Standards—Part of Audit Performed by Other Independent Auditors

AU sec. 543.12 is amended as follows:

When the principal auditor decides not to make reference to the audit of the other auditor, in addition to satisfying himself as to the matters described in AU sec. 543.10, the principal auditor must obtain, and review and retain, the following information from the other auditor:

a. An engagement completion document consistent with paragraphs 12 and 13 of PCAOB Auditing Standard No. 3.

Note: This engagement completion document should include all cross-referenced, supporting audit documentation.

b. A list of significant fraud risk factors, the auditor's response, and the results of the auditor's related procedures.

c. Sufficient information relating to significant findings or issues that are inconsistent with or contradict the auditor's final conclusions, as described in paragraph 8 of PCAOB Auditing Standard No. 3.

d. Any findings affecting the consolidating or combining of accounts in the consolidated financial statements.

e. Sufficient information to enable the office issuing the auditor's report to agree or reconcile the financial statement amounts audited by the other firm to the information underlying the consolidated financial statements.

f. A schedule of audit adjustments, including a description of the nature and cause of each misstatement.

g. All significant deficiencies and material weaknesses in internal control over financial reporting, including a clear distinction between those two categories.

h. Letters of representations from management.

i. All matters to be communicated to the audit committee.

The principal auditor must obtain, and review and retain, such documents prior to the report release date.[1] In addition, the principal auditor should consider performing one or more of the following procedures:

- Visit the other auditor and discuss the audit procedures followed and results thereof.

[1] As it relates to the direction in paragraph .19 of AU sec. 324, for the auditor to "give consideration to the guidance in section 543.12," the auditor need not, in this circumstance, obtain the previously enumerated documents.

- Review the audit programs of the other auditor. In some cases, it may be appropriate to issue instructions to the other auditor as to the scope of the audit work.
- Review additional audit documentation of the other auditor relating to significant findings or issues in the engagement completion document.

PCAOB Release No. 2004-007

Rule Regarding Certain Terms Used in Auditing and Related Professional Practice Standards

PCAOB Release No. 2004-007
June 9, 2004
PCAOB Rulemaking
Docket Matter No. 009

Summary:

After public comment, the Public Company Accounting Oversight Board (the "PCAOB" or "Board") has adopted Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*. The Board will submit this rule to the Securities and Exchange Commission ("SEC" or "Commission") for approval pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 (the "Act"). This rule will not take effect unless approved by the Commission.

Board Contacts:

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* * *

Section 103 of the Act directs the Board to establish auditing and related professional practice standards, including auditing, attestation, quality control, ethics, and independence standards, applicable to registered public accounting firms in the preparation and issuance of audit and other reports for public companies. To date, the Board has adopted rules that require registered public accounting firms and their associated persons to "comply with all applicable auditing and related professional practice standards," (Rule 3100) and designate as interim standards of the Board certain standards that existed as of April 16, 2003 (Rules 3200T—3600T).

On October 7, 2003, the Board proposed Rule 3101 to set forth the terminology the Board will use to describe the degree of responsibility that the auditing and related professional practice standards impose on registered auditors. As proposed, this terminology also would apply to the Board's interim standards. The Board believes that the use of clear, concise, consistent, and definitive imperatives will improve audit quality.

The Board received 12 comment letters from a variety of interested parties, including auditors, professional associations, and government agencies. In response to the comments received, several changes were made to the requirements of the rule, which are described in detail in Appendix 2.

Appendices 1 and 2 to this release contain, respectively, the text of Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*, and the Section-by-Section Analysis.

A. Introduction

Until now, the accounting profession has not expressly defined imperatives used to describe different degrees of the auditor's responsibility when conducting engagements in accordance with professional standards. Because of its concerns regarding the clarity in and consistency of existing standards, the Public Oversight Board's Panel on Audit Effectiveness recommended that the various levels of imperatives in auditing standards be clarified.[1] The Board agrees that defining these levels of imperatives will assist auditors with their work and further enhance the quality of audits.

Rule 3101 defines terminology the Board will use to describe the degrees of responsibility that the standards impose on the auditors as follows—

1. Unconditional Responsibility. The words "must," "shall," and "is required" indicate unconditional responsibilities. The auditor must fulfill responsibilities of this type in all cases in which the circumstances exist to which the requirement applies.
2. Presumptively Mandatory Responsibility. The word "should" indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type specified in the Board's standards unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard.
3. Responsibility To Consider. The words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a responsibility to consider. Matters described in this fashion require the auditor's attention and understanding. How and whether the auditor implements these matters in the audit will depend on the exercise of professional judgment in the circumstances consistent with the objectives of the standard.

B. Applicability to Interim Standards

Although the auditing and related professional practice standards did not previously expressly define the degree of responsibility attached to these terms, the Board determined that the terminology defined in Rule 3101 is consistent with the existing interpretation of the interim standards. The Board believes that applying Rule 3101 to all auditing and related professional practice standards, including the interim standards, will create a common understanding among auditors of performance expectations when conducting engagements in accordance with the PCAOB Standards. Therefore, the Board concluded that it is appropriate to apply the definitions of these particular terms to the interim standards.

C. Documentation Requirement for Presumptively Mandatory Responsibility

The integrity of the audit depends, in large part, on the existence of a complete and understandable record of the work performed, the conclusions reached, and the evidence obtained to support those conclusions. Clear, complete, and comprehensive audit documentation enhances the quality of the audit. Audit documentation should demonstrate compliance with professional standards and

[1] Panel on Audit Effectiveness, *Report and Recommendations* §2.228 (August 31, 2000).

provide an explanation to justify the reasons for any variations in procedures performed.

The PCAOB Standards require that the auditor document the procedures performed, evidence obtained, and conclusions reached during an engagement. To further enhance the quality of the audit, Rule 3101(a)(2) adds a specific documentation requirement to achieve complete and comprehensive audit documentation for situations in which the auditor does not perform a presumptively mandatory activity. In those instances, auditors must document the reasons they chose not to perform the presumptively mandatory activity and how the alternative procedure performed sufficiently achieved the objectives of the specific standard.

During an internal or external review of the engagement, other evidence, including oral explanation, may help substantiate the procedures performed by the auditor during the audit. However, because the auditor is required to document his or her work during the audit, oral explanation should be used only to clarify the documented work performed. Furthermore, the reviewer should give appropriate consideration to the credibility of the individual(s) providing the oral explanation, and the oral explanation should be consistent with the documented evidence.

D. Effective Date

Because of the specific documentation requirement in paragraph (a)(2) of this rule, the Board has determined that the implementation date for the documentation requirement contained in Rule 3101 should coincide with that of PCAOB Auditing Standard No. 3, *Audit Documentation*. Therefore, the documentation requirement for Rule 3101(a)(2) will be effective for audits of financial statements with respect to fiscal years ending on or after the later of November 15, 2004, or 30 days after the date of approval of this rule by the SEC. The remaining Rule 3101 provisions become effective immediately following approval by the SEC.

* * *

On the 9th day of June, in the year 2004, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Acting Secretary
June 9, 2004

APPENDICES—

1. Rule 3101—Certain Terms Used in Auditing and Related Professional Practice Standards
2. Section-by-Section Analysis of Rule 3101

Appendix 1

Rule Regarding Certain Terms Used in Auditing and Related Professional Practice Standards

RULES OF THE BOARD

SECTION 1. GENERAL PROVISIONS

Rule 1001. Definitions of Terms Employed in Rules

(a)(xi) Auditor

The term "auditor" means both public accounting firms registered with the Public Company Accounting Oversight Board and associated persons thereof.

SECTION 3. PROFESSIONAL STANDARDS

Part 1—General Requirements

Rule 3101. Certain Terms Used in Auditing and Related Professional Practice Standards

(a) The Board's auditing and related professional practice standards use certain terms set forth in this rule to describe the degree of responsibility that the standards impose on auditors.

(1) **Unconditional Responsibility:** The words "must," "shall," and "is required" indicate unconditional responsibilities. The auditor must fulfill responsibilities of this type in all cases in which the circumstances exist to which the requirement applies. Failure to discharge an unconditional responsibility is a violation of the relevant standard and Rule 3100.

(2) **Presumptively Mandatory Responsibility:** The word "should" indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type specified in the Board's standards unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard. Failure to discharge a presumptively mandatory responsibility is a violation of the relevant standard and Rule 3100 unless the auditor demonstrates that, in the circumstances, compliance with the specified responsibility was not necessary to achieve the objectives of the standard.

Note: In the rare circumstances in which the auditor believes the objectives of the standard can be met by alternative means, the auditor, as part of documenting the planning and performance of the work, must document the information that demonstrates that the objectives were achieved.

(3) **Responsibility To Consider**: The words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a responsibility to consider. Matters described in this fashion require the auditor's attention and understanding. How and whether the auditor implements these matters in the

audit will depend on the exercise of professional judgment in the circumstances consistent with the objectives of the standard.
Note: If a Board standard provides that the auditor "should consider" an action or procedure, consideration of the action or procedure is presumptively mandatory, while the action or procedure is not.

(b) The terminology in paragraph (a) of this rule applies to the responsibilities imposed by the auditing and related professional practice standards, including the interim standards adopted in Rules 3200T, 3300T, 3400T, 3500T, and 3600T.

(c) The documentation requirement in paragraph (a)(2) is effective for audits of financial statements or other engagements with respect to fiscal years ending on or after [insert date the later of November 15, 2004, or 30 days after approval of this rule by the Securities and Exchange Commission].

Appendix 2

Section-by-Section Analysis of Rule 3101

Rule 3101(a)

In drafting its standards, the Board intends to distinguish among three levels of auditor responsibility. Rule 3101(a) explains the terminology regarding imperatives used in the standards the Board establishes.

Rule 3101(a)(1) provides that the words "must," "shall," and "is required" in standards indicate unconditional responsibilities. The auditor must accomplish responsibilities of this type in all cases in which the circumstances exist to which the requirement applies. A failure to discharge an unconditional responsibility imposed under the Board's standards is a violation of the relevant standard and Rule 3100.

Rule 3101(a)(2) provides that the word "should" in standards indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard. In the rare circumstances in which the auditor believes the objectives of the standard can be met by alternative means, the auditor, as part of documenting the planning and performance of the work, must document the information that demonstrates that the objectives were achieved. The Board has determined that a failure to discharge a presumptively mandatory responsibility is a violation of the relevant standard and Rule 3100 unless the auditor demonstrates that, in the circumstances, compliance with the specified responsibility was not necessary to achieve the objectives of the standard.

Rule 3101(a)(3) provides that the words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a responsibility to consider. Matters described in this fashion require the auditor's attention and understanding. How and whether the auditor implements these matters in the audit will depend on the exercise of professional judgment in the circumstances.

The Board added the following captions to Rule 3101(a): 3101(a)(1) Unconditional Responsibility, 3101(a)(2) Presumptively Mandatory Responsibility, and 3101(a)(3) Responsibility To Consider. Proposed Rule 3101(a) did not have a caption or designation for each category of terms. Rather, the proposed rule simply referenced the category of certain terms by using the standard format in PCAOB rulemaking. The Board added the captions in response to a commenter's recommendation that a caption be added to each category of certain terms for ease of reference and clarity.

One commenter recommended replacing the term "obligation" in Rule 3101 with a comparable term because the commenter believed that the term "obligation" in legal and governmental environments has a connotation that is inconsistent with the intent of Rule 3101 and may be misinterpreted by legal or governmental officials. After considering this comment, the Board replaced the term "obligation" with the synonym "responsibility" in Rule 3101.

Rule 3101(a)(2) defines a presumptively mandatory responsibility as a requirement that the auditor must comply with "unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to

achieve the objectives of the standard." Furthermore, Rule 3101(a)(2) states that "failure to discharge a presumptively mandatory responsibility is a violation of the relevant standard and Rule 3100 unless the auditor demonstrates that, in the circumstances, compliance with the specified responsibility was not necessary to achieve the objectives of the standard."

The Board also added a note to Rule 3101(a)(2) to require auditors to document compliance with presumptively mandatory responsibilities by alternative means. The Board originally proposed that the auditor be required to "demonstrate by verifiable, objective, and documented evidence" that the alternative procedures he or she followed were sufficient in the specific circumstances. Commenters stated that they believed that the documentation requirement was important, both to promote discipline of thought and to provide a uniform basis for evaluating compliance with the standards. Several of these commenters went even further to recommend that the Board strengthen the documentation requirement by adding language such as "contemporaneous" and "memorialized at the time of the audit" to the rule.

Conversely, other commenters suggested that the documentation requirement was unduly onerous and placed too great a documentation burden on the auditors. The commenters argued that the documentation would be too voluminous and would add very little value to the audit. Some of these commenters further recommended that, in lieu of the proposed documentation requirement, the rule require that the auditor consider the significance of the particular audit area and document only the significant issues or findings. A commenter also recommended that other evidence, such as oral explanation, should be allowed as support for the reasons why the auditor chose not to perform a presumptively mandatory responsibility. Additionally, some commenters recommended that the documentation requirement should be addressed in the standard on audit documentation.

The integrity of the audit depends, in large part, on the existence of a complete and understandable record of the work performed, the conclusions reached, and the evidence obtained to support those conclusions. Clear, complete, and comprehensive audit documentation enhances the quality of the audit. Audit documentation should demonstrate compliance with professional standards and justify the reasons for any variations in procedures performed.

The PCAOB Standards require the auditor to document the procedures performed, evidence obtained, and conclusions reached during an engagement. To further enhance the quality of the audit, Rule 3101(a)(2) adds a specific documentation requirement to achieve complete and comprehensive audit documentation in engagement working papers for situations in which the auditor does not perform a presumptively mandatory responsibility. In those instances, it is essential that auditors document the reasons they chose not to perform the presumptively mandatory responsibility and how the alternative procedure they performed sufficiently achieved the objectives of the specific standard.

Because circumstances will be rare in which the auditor will perform an alternative procedure, the Board anticipates that the documentation requirement in the rule ought not to result in unduly onerous consequences or too voluminous documentation. Furthermore, since the auditor must already document the work performed as part of the audit, adding a concise explanation as to why the auditor chose to perform the alternative procedure should not increase the volume of documentation to an unreasonable level.

During an internal or external review of the engagement, other evidence, including oral explanation, may help substantiate the procedures performed by the auditor during the audit. However, because the auditor is required to document his or her work in the engagement working papers during the audit, oral explanation should be used only to clarify the documented work performed. The justification as to why the alternative procedure was performed rather than the presumptively mandatory responsibility must be documented in the working papers. Furthermore, the reviewer should give appropriate consideration to the credibility of the individual(s) providing the oral explanation, and the oral explanation should be consistent with the documented evidence in the engagement working papers.

Moreover, the Board concluded that applying the documentation requirement only to significant issues, findings, or procedures is impractical because it will not be efficient or effective to determine, each time, whether the level of significance of an audit area warranted the auditor to document the reasons for choosing to perform an alternative procedure instead of the presumptively mandatory procedure. The purpose of Rule 3101 is to bring uniformity to definitions and requirements that auditors have to follow. In addition, the Board determined that moving Rule 3101(a)(2)'s documentation requirement to the audit documentation standard would not be appropriate because of its specific subject matter.

Additionally, the Board has added a note, originally a footnote in the Board's proposing release accompanying its proposed rule, describing an auditor's responsibility in a "should consider" scenario to the text of Rule 3101(a)(3), Responsibility to Consider. Some commenters recommended that this footnote be added directly to the text of the rule because they saw it as an important clarification that was not included in the original proposed rule. A commenter further urged the Board to elaborate on its applicability and the documentation requirements for a "should consider" action.

Another commenter suggested that the "should consider" footnote be excluded from the rule because it implies that the action would require the auditor to document every instance of compliance with a "should consider" action. The commenter, instead, recommended that Rule 3101(a)(3) be revised to apply to all considerations regardless of how the obligation is expressed (for example, whether it is preceded by a "should," "may," "could," or "might").

Because the "should consider" terminology is widely used in the interim standards, the Board determined that it is important to state the Board's expectation for compliance and, therefore, agreed with commenters who recommended adding the "should consider" footnote to the text of Rule 3101(a)(3). Furthermore, the Board concluded that there is an important difference between a "should consider" and a "may consider" action or procedure. The difference is a direct correlation to the definitions of "should" and "may." The auditor has a greater responsibility in a "should consider" action because the auditor has a presumptively mandatory responsibility to consider the action or procedure versus just having a responsibility to consider the action. Therefore, Rule 3101(a)(3) was not revised to apply to all considerations regardless of how the obligation is expressed.

Additionally, the Board determined that the documentation requirement relating to a procedure that an auditor "should consider" is not the same as the documentation requirement for a presumptively mandatory responsibility because in a "should consider" situation, only the consideration of the action

is presumptively mandatory, while the action or procedure itself is not. In these situations, the auditor should use his or her professional judgment in determining how to document his or her consideration of the specific action or procedure.

Rule 3101(b)

Rule 3101(b) provides that the terminology in paragraph (a) of this rule applies to all the auditing and related professional practice standards, including the interim standards adopted in Rules 3200T, 3300T, 3400T, 3500T, and 3600T. Rule 3101(b) applies to conduct occurring after the effective date of the rule.

Therefore, Rule 3101(b) provides that the terminology in Rule 3101(a) is applicable to all existing auditing and related professional practice standards with which auditors must comply. The Board determined that a failure to comply with a presumptively mandatory responsibility in an interim standard will be treated as a violation of the relevant standard and Rule 3100 unless the auditor demonstrates that, in the specific circumstances, compliance was not necessary to achieve the objectives of the standard.

Some commenters on the proposed rule stated that the imperatives the Board identified are consistent with the way auditors currently interpret existing auditing and related professional practice standards, while other commenters recommended that Rule 3101(a) not apply to the interim standards on the grounds that the new definitions could create confusion or have unintended consequences. Because the accounting profession previously had not expressly defined these terms, commenters further recommended that the Board perform a comprehensive analysis of how and in what context the interim standards use the defined terms to determine whether current practice is consistent with the Rule 3101(a) definitions.

The Board concluded that the terminology defined in Rule 3101 is consistent with the existing interpretation regarding the application of the terminology in the interim standards. Rule 3101 creates a common understanding among the auditors as to what is expected of them when performing engagements in accordance with the PCAOB Standards and, therefore, Rule 3101 will apply to the interim standards.

Furthermore, a commenter recommended that the Board clarify the level of authority the appendices carry when accompanying the Board's Standards. Because the Board adopts the appendices to its permanent standards as rules, the appendices to the Board's permanent standards carry the same level of authority as the standards themselves. In addition, the appendices to the interim standards, which in certain circumstances carry a different level of authority, retain their original level of authority as adopted on April 16, 2003.

Rule 3101(c)

Rule 3101(c) establishes an effective date for the documentation requirement in paragraph (a)(2). The Board agreed with commenters who recommended establishing an effective date to provide a reasonable amount of time for auditors to implement procedures to properly comply with the new documentation requirement.

Rule 3101 does not apply retroactively. Therefore, conduct occurring before the rule is effective will be evaluated in light of the standards as they existed at

the time of the conduct. As noted above, however, the Board believes that, except for the documentation requirement in Rule 3101(a)(2), the definitions in Rule 3101 are consistent with the existing interpretation of these terms in the existing, interim standards. Therefore, as an interpretive matter, the Board expects that it will interpret these terms in the existing, interim standards in a manner consistent with their definitions in Rule 3101, in light of the facts and circumstances of each particular situation.

PCAOB Release No. 2005-014

Ethics and Independence Rule Concerning Independence, Tax Services, and Contingent Fees

PCAOB Release No. 2005-014
July 26, 2005
PCAOB Rulemaking
Docket Matter No. 017

Approved by the Securities and Exchange Commission on April 19, 2006, with varying effective dates.

The Securities and Exchange Commission has approved PCAOB ethics and independence rules concerning independence, tax services and contingent fees.

The rules introduce a foundation for the independence component of the Board's ethics rules by establishing a general obligation requiring a registered public accounting firm and its associated persons to be independent of the firm's audit clients throughout the audit and professional engagement period.

The rules identify circumstances in which the provision of tax services impairs an auditor's independence, including services related to marketing, planning, or opining in favor of the tax treatment of, among other things, transactions that are based on aggressive interpretations of applicable tax laws and regulations.

The rules also treat registered public accounting firms as not independent of their audit clients if they enter into contingent fee arrangements with those clients or if the firms provide tax services to certain members of management who serve in financial reporting oversight roles at an audit client or to immediate family members of such persons.

The rules further implement the Sarbanes-Oxley Act's requirement that auditors' non-audit services be pre-approved by the audit committee by strengthening the auditor's responsibilities in connection with seeking audit committee pre-approval of tax services. Specifically, the rules require a registered public accounting firm that seeks such pre-approval to describe proposed tax services engagements, in writing, for the audit committee; to discuss with the audit committee the potential effects of the services on the firm's independence; and to document the substance of that discussion.

Finally, an ethics rule also codifies the principle that persons associated with a registered public accounting firm (e.g., individual accountants) can be held responsible when certain of their actions contribute to a firm's violation of relevant laws, rules, or professional standards.

The effective dates for the rules follow:

Rule	Effective Date
3501—Definition of Terms	April 29, 2006
3502—Responsibility Not to Knowingly or Recklessly Contribute to Violations	April 29, 2006
3520—Auditor Independence	April 29, 2006
3521—Contingent Fees	Rule 3521 will not apply to contingent fee arrangements that were paid in their entirety, converted to fixed fee arrangements, or otherwise unwound before June 18, 2006.
3522—Tax Transactions	Rule 3522 will not apply to tax services that were completed by a registered public accounting firm no later than June 18, 2006.
3523—Tax Services for Persons in Financial Reporting Oversight Roles	Rule 3523 will not apply to tax services being provided pursuant to an engagement in process on April 19, 2006, provided that such services are completed on or before October 31, 2006.
3524—Audit Committee Pre-approval of Certain Tax Services	Rule 3524 will not apply to any tax service pre-approved on an engagement-by-engagement basis before June 18, 2006. With respect to tax services provided to audit clients whose audit committees pre-approve tax services pursuant to policies and procedures, Rule 3524 will not apply to any such tax service that is begun by April 20, 2007.

Summary:

The Public Company Accounting Oversight Board ("PCAOB" or "Board") is adopting rules to promote the ethics and independence of registered public accounting firms that audit financial statements of U.S. public companies. The rules treat a registered firm as not independent of a public company audit client if the firm, or an affiliate of the firm, provided any service or product to an audit client for a contingent fee or a commission, or received from an audit client, directly or indirectly, a contingent fee or commission. The rules also treat such a firm as not independent if the firm, or an affiliate of the firm, provided assistance in planning, or provided tax advice on, certain types of potentially abusive tax transactions to an audit client or provided any tax services to certain persons employed by an audit client. Further, the rules require registered public accounting firms to provide certain information to audit committees in connection with seeking pre-approval to provide non-prohibited tax services.

In addition to these rules relating to tax services, the Board also is adopting a general rule requiring registered public accounting firms and their associated persons to be independent of their audit clients throughout the audit and professional engagement period. Finally, the Board is adopting a rule on the responsibility of persons associated with registered public accounting firms not to cause registered public accounting firms to violate the Sarbanes-Oxley Act of 2002 (the "Act"), the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Securities and Exchange Commission issued under the Act, and professional standards.

Public Comments:

The Board released for public comment proposed rules to promote the ethics and independence of registered public accounting firms on December 14, 2004. The Board received 805 letters of comment.

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I. Final Rules on Auditors' Provision of Tax Services

On December 14, 2004, the Board proposed certain rules related to registered public accounting firms' provision of tax services to public company audit clients. The proposal was designed to address certain concerns related to auditor independence when auditors become involved in marketing or otherwise opining in favor of aggressive tax shelter schemes and in selling personal tax services to individuals who play a direct role in preparing the financial statements of public company audit clients. The proposal was also based on the Board's recognition of the fact that accounting firms have long offered basic tax compliance services that have not raised significant questions about those firms' ability also to serve as independent auditors. The Board received 805 comment letters from investors, auditors, issuers, and others, most of whom, in general, supported the proposed rules.[1]

Neither the federal securities laws nor the SEC's rules prohibit auditors from providing tax services to their audit clients, so long as such services are preapproved by a company's audit committee (and so long as those services do not fall into one of several enumerated categories of expressly prohibited services).[2] The SEC has recognized, however—most recently in connection with promulgating rules to implement the auditor independence provisions of Title II of the Act[3]—that while it did not consider conventional tax compliance and planning to be a threat to auditor independence, the marketing of novel, tax-driven financial products raises more challenging auditor independence issues.

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[1] Seven hundred forty of these comment letters were from individual investors expressing strong support for the proposal.

[2] On February 5, 2003, the Securities and Exchange Commission ("SEC" or "Commission") adopted rules to implement Title II of the Sarbanes-Oxley Act of 2002 (the "Act"). These rules address key aspects of auditor independence with special emphasis on the provision of non-audit services. The rules expressly prohibit ten categories of non-audit services, as required by Section 201 of the Act. Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Release No. 33-8183, § II.B.11 (Jan. 28, 2003), 17 C.F.R. Parts 210, 240, 249, and 274.

[3] See id.

On this basis, the SEC has cautioned that an audit committee should "scrutinize carefully" the retention of the company's auditor in a transaction initially recommended by the auditor "the sole business purpose of which may be tax avoidance and the tax treatment of which may be not supported in the Internal Revenue Code and related regulations."[4]

In addition to requiring the SEC to establish rules implementing the Act's prohibition of certain non-audit services, the Act vested in the PCAOB the authority to establish standards relating to ethics and independence in public company auditing. Specifically, Section 103(a) of the Act directs the Board, by rule, to establish "ethics 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." Moreover, Section 103(b) of the Act directs the Board to establish such rules on auditor independence "as may be necessary or appropriate in the public interest or for the protection of investors, to implement, or as authorized under, Title II of th[e] Act."[5]

As discussed more fully in the Board's proposing release, since the SEC issued its new rules, two types of tax services have raised serious concerns among investors, auditors, lawmakers, and others relating to the ethics and independence of accounting firms that provide both auditing and tax services—

1. the marketing to public company audit clients of questionable tax transactions used improperly to avoid paying taxes or to manipulate financial statements in order to make such statements appear more favorable to investors, and
2. the provision of tax services, including tax shelter products, to executives of public company audit clients who are involved in the financial reporting process at such companies.

Indeed, in an April 2005 report issued since the Board's proposal, the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs (the "Subcommittee") found that some of the nation's largest accounting firms had in the past sold generic tax products to multiple corporate and individual clients despite evidence that some of those products were potentially abusive or illegal.[6] In addition, the Internal Revenue Service ("IRS") and the

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[4] Id. Moreover, the SEC's release accompanying its rules referred to the recommendation of the Conference Board's Commission on Public Trust and Private Enterprise that, as a "best practice," auditors not provide advice on "novel and debatable" tax strategies and products. Id. §II.B.11 at note 112.

[5] Pursuant to this authority, in April 2003, the Board adopted as its interim, transitional, independence standards (PCAOB Rule 3600T) the American Institute of Certified Public Accountants ("AICPA") *Code of Professional Conduct* Rule 101 and related interpretations and rulings thereof, as they existed on April 16, 2003. PCAOB Rule 3600T notes that the interim standards do not supersede the Commission's auditor independence rules and, to the extent that a provision of the Commission's rules is more restrictive (or less restrictive) than the interim standards, the auditor must comply with the more restrictive rules. The PCAOB also adopted Independence Standards Board ("ISB") Standard Nos. 1, 2, and 3 and Interpretations 99-1, 00-1, and 00-2 as additional interim independence standards.

[6] See Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, The Role of Professional Firms in the U.S. Tax Shelter Industry, S. REP. No. 109-54, at 6 (2005) (hereinafter "April 2005 Senate Report"). This report was based on a Subcommittee investigation that included hearings, in November 2003, in which the Subcommittee elicited testimony that described certain potentially abusive tax shelter products marketed through cold-call selling techniques by accounting firms and others. *See also U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals: Hearings Before the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs*, 108th Cong. (2003) (hereinafter "U.S. Tax Shelter Hearings").

U.S. Department of Justice have brought a number of cases against accounting firms in connection with those firms' marketing of tax shelter products and, specifically, those firms' alleged failures to register, or comply with list maintenance requirements relating to, their tax shelter products. Most recently, earlier this year, the IRS proposed a settlement initiative for executives and companies that participated in certain abusive tax avoidance transactions, at times with the assistance of the companies' auditors.[7] At the time the initiative was announced, IRS Commissioner Mark W. Everson said that "[t]hese transactions raise[d] questions not only about compliance with the tax laws, but also, in some instances, about corporate governance and auditor independence."[8] Specifically, the IRS concluded that "[r]eal or perceived conflicts of interest may exist where independent auditors certify to the public the accuracy and integrity of the company's financial statements and these auditors advise senior executives on their personal tax issues about abusive tax shelters they promoted, the same executives that oversee the relationship with the auditing firm."[9]

The Government Accountability Office ("GAO") also has noted concerns about auditors' involvement in marketing abusive tax shelters to public companies. The GAO recently reported that 61 Fortune 500 companies obtained tax shelter services from their external auditors during the period 1998 through 2003.[10] The GAO also noted that the IRS considered some of these "transactions abusive, with tax benefits subject to disallowance under existing law, and other transactions possibly to have some traits of abuse."[11]

While other organizations have focused on a variety of legal and ethical issues presented by the tax shelter business, the Board's proposal focused on whether tax services generally, or any class of tax services, impair an auditor's independent judgment, in fact or appearance, in its audit work. Thus, over several months, the Board considered a wide range of tax services, including routine tax return preparation and tax compliance; tax planning and advice relating to federal, state, local, and other tax laws; executive tax services; international assignment tax services; and tax shelter strategies and products. To assist the Board in its evaluation, the Board held a public roundtable discussion with individuals representing a variety of viewpoints, including investors, auditors, managers of public companies, governmental officials, and others.[12]

Based on this evaluation, the Board developed a set of proposed rules designed to establish a framework for addressing the concerns that have arisen in connection with auditors' provision of tax services to their public company audit

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[7] Announcement 2005-19, 2005-11 I.R.B. 1.

[8] Internal Revenue Service ("IRS") News Release, Settlement Offer Extended for Executive Stock Option Scheme, IR 2005-17 (Feb. 22, 2005), *available at* http://www.irs.gov/newsroom/article/0,,id=135596,00.html. Commissioner Everson also said, "We believe a new climate under Sarbanes-Oxley, together with the tougher independence standards for auditors recently proposed by the Public Company Accounting Oversight Board make this sort of thing less likely going forward." Id.

[9] Announcement 2005-19, 2005-11 I.R.B. 1.

[10] See Tax Shelters: Provided by External Auditors, GAO-05-171 (2005) (hereinafter "GAO Tax Report").

[11] Id.

[12] The Board held the Auditor Independence Roundtable on Tax Services (the "Roundtable") on July 14, 2004. A list of Roundtable participants may be found at pages 2 and 3 of the transcript of the Roundtable. *See Auditor Independence Roundtable on Tax Services* (July 14, 2004), *available at* http://pcaobus.org/Rules/Rulemaking/Docket017/2004-07-14_Roundtable_Transcript.pdf.

clients. Specifically, the proposed rules were designed, among other things, to prevent auditors from providing (1) certain aggressive tax shelter services to public company audit clients, (2) any other service to a public company audit client for a contingent fee, which is a fee arrangement often used in tax work, and (3) any tax service to certain persons who serve in financial reporting oversight roles at a public company audit client. The proposed rules also would implement the requirements of the Act and the SEC's independence rules when an auditor seeks audit committee pre-approval to provide tax services that are not prohibited by the Board's or the SEC's rules.

The Board also sought comment on whether additional types of tax services, such as tax compliance services, should be prohibited by a Board rule. After carefully considering the comments received on this issue, most of which supported the Board's preliminary determination to exclude certain kinds of tax services from the purview of its proposed rules, the Board has determined to adopt the rules, substantially as proposed, and not to restrict auditors' provision of other kinds of tax services. That is, auditors may continue to provide to their public company audit clients other kinds of tax services not expressly prohibited by the Board's rules, so long as such services are consistent with the Commission's independence requirements and so long as the auditor and audit committee have complied with the Act's and the Commission's requirements relating to audit committee pre-approval of such services.

There is some evidence that accounting firms already recognize the risks that involvement in clients' abusive tax shelters can pose, as well as the problems that can result from providing tax services to executives of audit clients. And, there is some evidence that such firms have made changes to their oversight of firm services in order to avoid such problems in the future. For example, in its April 2005 report, the Subcommittee found that, since the Subcommittee's investigation began, some of the largest firms had each committed to, among other things, "cultural, structural, and institutional changes to dismantle its tax shelter practice. . . ."[13] Moreover, some firms have announced significant internal reforms designed to restore confidence in the ethics and independence of their audit practices.

Against this backdrop, commenters generally supported the Board's proposal. In addition, the Subcommittee recommended in its April 2005 report that "the Public Company Accounting Oversight Board . . . strengthen and finalize proposed rules restricting certain accounting firms from providing aggressive tax services to their audit clients, charging companies a contingent fee for providing tax services, and using aggressive marketing efforts. . . ."[14] Also, the IRS noted its support for the Board's proposal in its response to the GAO's report on Tax Shelters.[15]

Accordingly, today the Board is adopting final rules based on its December 2004 proposal. These final rules reflect modifications of the proposal in certain respects, largely due to insights derived from the Board's consideration of the comments received. Part II of this release describes the final rules, as well as modifications from the proposed version of the rules.

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[13] April 2005 Senate Report, *supra* note 6, at 6-7.

[14] April 2005 Senate Report, *supra* note 6, at 8.

[15] *See* GAO Tax Report, *supra* note 10, at 21 (in the IRS's official response to the GAO's report, IRS Commissioner Everson noted that "We support the December 2004 actions of the PCAOB on this problem!").

II. Detailed Discussion of Rules and Consideration of Comments

The Board's final rules are intended to accomplish four objectives. First, the rules codify, in an ethics rule, the principle that persons associated with a registered public accounting firm should not cause the firm to violate relevant laws, rules, and standards. Second, the rules introduce a foundation for the independence component of the Board's ethics rules. That foundation includes a fundamental independence requirement and, as necessary and appropriate, additional rules addressing specific circumstances related to independence issues.

Third, the rules build on that foundation with provisions that identify certain impairments to an auditor's independence. Specifically, the rules treat a firm as not independent if it, or any of its affiliates, enters into a contingent fee arrangement relating to an audit client. Also, the rules treat a firm as not independent if it, or any of its affiliates, markets, plans, or opines in favor of certain types of aggressive tax transactions to or for public company audit clients. In addition, the rules treat a firm as not independent if it, or any of its affiliates, provides tax services to certain persons in a financial reporting oversight role at an audit client or to immediate family members of such persons.

Fourth, the rules require registered public accounting firms to provide audit committees certain information in connection with seeking pre-approval from such committees, as required by the Act and the SEC's independence rules, to perform nonprohibited tax services for the audit client. The rules would require a firm seeking preapproval to describe the terms of the tax services engagement to the audit committee and to engage in a substantive discussion with the audit committee about the potential effects of such services on the firm's independence.[16]

A. Responsibility Not to Cause Violations

Rule 3502, as proposed, provided that a person associated with a registered public accounting firm shall not cause that firm to violate the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards, due to an act or omission the person knew or should have known would contribute to such violation. The Board proposed the rule to codify the ethical obligation of associated persons of registered firms not to cause registered firms to commit such violations. Proposed Rule 3502 also made clear that an associated person's ethical obligation is not merely to refrain from knowingly causing a violation but also to act with sufficient care to avoid negligently causing a violation.

The Board received a number of comments on proposed Rule 3502. Several commenters supported the rule as proposed and noted that they saw the rule as essential to the Board's ability to carry out its disciplinary responsibilities under the Act. Other commenters, however, including the largest accounting firms and an accounting trade association, did not support the rule as proposed. In general, these commenters objected to the proposed rule's use of a negligence standard in light of the complex regulatory requirements with which auditors

[16] The rules also include several definitions that are integral to the operation of the rules.

must comply. Some of these commenters also questioned the Board's authority to adopt the proposed rule, or at least the proposed rule with a negligence standard.

The Board has carefully considered these comments and determined to adopt Rule 3502, with some modifications. The Board continues to believe that it is authorized to adopt the rule. Section 103(a) of the Act directs the Board to, "by rule, establish . . . such ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by this Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." The Board believes that the rule is an appropriate exercise of this authority to set ethical standards for accountants subject to the Board's jurisdiction.

Under the Act and Board rules, both registered firms and their associated persons must comply with PCAOB rules and standards, as well as related laws. When an associated person with such a responsibility causes the firm with which he or she is associated to violate such rules, standards or laws, this conduct operates to the detriment of the protection of investors and the public interest and may bear on the ethics of the responsible associated person. When such a person engages in this conduct with knowledge that, or in reckless disregard of whether, it would directly and substantially contribute to the firm's violation, the Board believes this conduct plainly reflects an ethical lapse by the responsible person and, therefore, is within the Board's authority—and indeed responsibility—to proscribe.

At least one commenter asserted that the proposed rule was not a proper exercise of the Board's ethics standards-setting authority because it reached a range of conduct, rather than delineating "particular impermissible conduct." The Board disagrees and believes the type of conduct addressed by the rule is plainly the type of conduct the Board's ethics rules can and should address. In fact, the accounting profession's existing ethical code at the time of enactment of the Act reaches any act that may "discredit[]" the profession—thereby reaching ranges of conduct, including violations of certain laws, rather than just specifying "particular impermissible conduct."[17] When Congress vested the authority to set ethics standards in the Board, the Board believes it intended for this authority to be at least as broad as the scope of the existing ethics rules, at least as to matters within the Board's jurisdiction. This authority, in the Board's view, plainly includes the ability to require that persons subject to the Board's jurisdiction, as an ethical obligation, not cause a violation of relevant laws.

Commenters opposed to the proposed rule also sought to analogize the rule to a theory of liability that the Supreme Court rejected in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*[18] In *Central Bank*, the Supreme Court held that that there is no private right of action for aiding and abetting a violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"). That decision turned on the fact that the text of Section 10(b)

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[17] *See AICPA Code of Professional Conduct*, ET section ("sec.") 501, "Acts Discreditable" ("A member shall not commit an act discreditable to the profession."). Interpretations of this part of the ethical code provide that an accountant member will be considered to have committed a discreditable act if, among other things, he or she: "fails to comply with applicable federal, state or local [tax] laws or regulations," ET sec. 501.08, Interpretation 501-7; fails to follow applicable requirements of a governmental body, such as the SEC, in performing accounting services, ET sec. 501.06, Interpretation 501-5; or fails to follow government audit standards and rules in conducting a governmental audit, ET sec. 501.04, Interpretation 501-3.

[18] 511 U.S. 164 (1994).

does not provide for aiding-and-abetting liability.[19] The Board does not believe this decision affects the scope of the Board's explicit authority to set ethics standards under Section 103 of the Act.[20] Again, the Board notes that the profession's existing ethics code also reaches what can be characterized as "secondary" conduct contributing to a violation.[21]

The power to adopt Rule 3502 also is inherent in, and necessary to, the Board's authority to enforce PCAOB standards, rules, and related laws against both registered firms and their associated persons. Section 105 authorizes the Board to investigate and, when appropriate, discipline registered firms and their associated persons. Certain types of violations, by their nature, may give rise to direct liability only for a registered public accounting firm. Such firms, however, can only act through the natural persons that comprise them, many of whom are "associated persons" subject to the Board's ethics standards and disciplinary authority. When one or more of those associated persons has caused that firm to violate PCAOB standards, rules, or related laws with the requisite state of mind, it is appropriate, and consistent with the Board's duty to discipline registered firms and their associated persons under Section 101(c)(4) of the Act, that the Board be able to discipline the associated person for that misconduct.[22]

After carefully considering the comments received, the Board has determined, however, to modify the scope of Rule 3502 to apply only when an associated person causes the registered firm's violation due to an act or omission the person "knew, or was reckless in not knowing, would directly and substantially contribute to such violation." This revised formulation reflects two changes to the rule as proposed.

First, the Board has determined to change the state-of-mind requirement in the rule. Specifically, Rule 3502, as adopted, will apply to "an act or omission the [associated] person knew, or was reckless in not knowing," would cause the violation. While the Board believes it has the authority to adopt a negligence standard,[23] the Board believes the revised standard strikes the right balance in the context of this rule. The Board believes that the phrase "knew, or was reck-

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[19] See id. at 190 ("Because the text of §10(b) does not prohibit aiding and abetting, we hold that a private plaintiff may not maintain an aiding and abetting suit under §10(b).").

[20] Rule 3502, of course, differs from an aiding-and-abetting cause of action in important respects. Among other things, the rule does not apply whenever an associated person causes another to violate relevant laws, rules and standards. Rather, Rule 3502 applies only when an associated person causes a violation by the registered firm with which the person is associated.

[21] *See AICPA Code of Professional Conduct*, paragraph .02(2) of ET sec. 91, "Applicability" ("A member shall not knowingly permit a person, whom the member has the authority or capacity to control, to carry out on his or her behalf, either with or without compensation, acts which, if carried out by the member, would place the member in violation of the rules. Further, a member may be held responsible for the acts of all persons associated with him or her in the practice of public accounting whom the member has the authority or capacity to control."); *see also* ET sec. 102.02, Interpretation 102-1(c) (violation of ethics rules not just to sign, but to "permit[] or direct[] another to sign a document containing materially false and misleading information") (adopted as a Board interim ethics rule in Rule 3500T).

[22] Some commenters suggested that the reference to "any act, or practice . . . in violation of this Act" in Section 105(c)(4)—the part of the Act authorizing the Board to impose certain sanctions—was inconsistent with the proposed rule. The Board notes, however, as it did in the proposing release, that Section 105(c)(5) expressly provides that the more severe of these sanctions may be imposed when intentional, knowing, or reckless conduct, or repeated instances of negligent conduct, "results in" violation of law, regulations, or professional standards.

[23] A number of commenters argued that Section 105(c) of the Act prevents the Board from imposing discipline based on a negligence standard. The Board's determination to change the rule's state-of-mind requirement to recklessness moots these comments. The Board notes, however, that Section 105(c)(5) identifies a range of sanctions that the Board may not impose in the absence of knowing conduct, reckless conduct, or repeated instances of negligent conduct. The Act does not similarly limit the Board's authority to impose certain other sanctions.

less in not knowing" is a wellunderstood legal concept, and the Board intends for the phrase to be given its normal meaning.

Second, the Board has determined to modify the phrase used to describe the connection between the associated person's conduct and the violation. Specifically, Rule 3502, as adopted, provides that the associated person's act or omission must "directly and substantially contribute to [the firm's] violation." In particular, "substantially" in this context means that the associated person's conduct (i.e., an act or omission) contributed to the violation in a material or significant way. The term "substantially" also means, however, that the associated person's conduct does not need to have been the sole cause of the violation. "Directly" means that the associated person's conduct either essentially constitutes the violation—even though it is the firm and not the individual that actually commits the violation—or is a reasonably proximate facilitating event of, or a reasonably proximate stimulus for, the violation. "Directly and substantially" does not mean that the associated person's conduct must be the sole cause of the violation, nor that it must be the final step in a chain of actions leading to the violation. In addition, the term "directly" should not be misunderstood to excuse someone who knowingly or recklessly engages in conduct that substantially contributes to a violation, just because others also contributed to the violation, or because others could have stopped the violation and did not. At the same time, the term does not reach an associated person's conduct that, while contributing to the violation in some way, is remote from, or tangential to, the firm's violation.

A number of commenters expressed concern that adoption of a negligence standard would allow the Board, or the SEC, to proceed against associated persons who in good faith, albeit negligently, have caused a registered firm to violate applicable laws or standards. For example, commenters suggested that the proposed rule could be used against compliance personnel within a firm who inadvertently design a firm's compliance system in a flawed manner. Commenters also expressed concern that, because the SEC can enforce PCAOB rules under Section 3 of the Act, the Board's rule could have the practical effect of altering the state-of-mind requirement applicable in SEC enforcement proceedings against accountants.

It was not the Board's intention to establish a new standard for SEC enforcement of the securities laws and related applicable rules. The Board also recognizes that persons subject to its jurisdiction must comply with complex professional and regulatory requirements in performing their jobs. The Board does not seek to create through this rule a vehicle to pursue compliance personnel who act in an appropriate, reasonable manner that, in hindsight, turns out to have not been successful. Nor does the Board seek to reach those whose conduct, unbeknownst to them, remotely contributes to a firm's violation. At the same time, the Board continues to believe that it is necessary and appropriate for its ethics rules to apply when an associated person has engaged in an act or omission with knowledge that, or in reckless disregard of whether, it would directly and substantially contribute to a violation.[24]

The Board also believes that, because the rule is essential to the functioning of the Board's independence rules, this rulemaking provides the appropriate forum to adopt the rule. For example, Rule 3521 provides, in part, that a registered firm is not independent of its audit client if the firm provides that audit client with a service for a contingent fee. When an associated person causes, in

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[24] While the Board's proposed rule tracked some of the language of Section 21C of the Securities Exchange Act of 1934 ("Exchange Act'), the rule, as adopted, differs significantly from, and should not be interpreted in pari material with, that statutory provision.

a manner consistent with the discussion above, the registered firm to provide that service for a contingent fee, Rule 3502 would allow the Board to discipline the associated person for that conduct.[25]

B. Ethics and Independence

The final rules also create a foundation for the independence requirements of the Board's ethics rules. The rules introduce a new "Independence" subpart in the ethics rules. That subpart begins with Rule 3520, which articulates the fundamental independence requirement. The final rules also include additional rules that describe independence impediments in the particular context of contingent fee arrangements and tax services.

1. The Fundamental Independence Requirement

Rule 3520 sets forth the fundamental ethical obligation of independence: a registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period. This requirement encompasses the independence requirements set out in PCAOB Rule 3600T and goes further, as a matter of the auditor's ethical obligation, to encompass any other independence requirement applicable to the audit in the particular circumstances. Accordingly, in the case of an audit client subject to the financial reporting requirements of the securities laws and the SEC's rules, the ethical obligation under Rule 3520 requires the firm and its associated persons to maintain independence consistent with the SEC's requirements.[26]

By giving this scope to Rule 3520, the Board is not promulgating any new independence requirement. The Commission's independence requirements exist independently of Rule 3520 and are subject to change at the discretion of the Commission, without Rule 3520 purporting separately to lock in place any aspect of those requirements. Instead, Rule 3520 is based on the simple premise that ethical standards for auditors can and should encompass a duty by the auditor to maintain independence necessary to ensure compliance with independence requirements in the circumstances of the particular engagement.

A note to the rule emphasizes the scope of the obligation in the rule by pointing out that, even in circumstances to which the Commission's Rule 2-01 applies, a registered public accounting firm and its associated persons still may need to comply with other independence requirements, including those requirements separately established by the Board. Using this foundation, the Board may adopt additional rules in the "Independence" subpart of the ethics rules that effectively set out additional requirements. As described below, with the new rules adopted today, the Board's independence rules include contingent fee arrangements and tax services.

After carefully considering the comments on proposed Rule 3520, the Board has determined to adopt the rule, with only one change. Most commenters supported the scope and content of the proposed rule. A few commenters, however, asked

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[25] Rule 3502, of course, is not the exclusive means for the Board to enforce applicable Board rules and standards against associated persons. Among other provisions, Rules 3100 and 3200T through 3600T directly require associated persons to comply with certain auditing and related professional practice standards. In addition, PCAOB standards generally contain directives to the "auditor." The term "auditor" is defined in PCAOB Rule 1001(a)(xii) to include both registered firms and their associated persons. Accordingly, an associated person of a registered firm that does not comply with such a directive may be charged with violations of such other standards, independent of any charges under Rule 3502.

[26] 17 C.F.R. § 210.2-01.

the Board to add text to the proposed rule to clarify or emphasize that the rule incorporates certain concepts in the existing independence requirements. While these comments are discussed in more detail below, the Board did not adopt these suggestions, as a general matter, because of the purpose of Rule 3520. Rule 3520 was simply intended to require, by Board rule, compliance with applicable independence requirements. The rule was not intended to, and does not, add to—or subtract from—these existing requirements. Nor is it intended to reflect the Board's conceptual approach to independence issues. Accordingly, while the Board does not necessarily disagree with the intent of the commenters who suggested adding text to the proposed rule, it does not believe it is necessary or appropriate to modify the rule to reflect their specific suggestions.

Three commenters suggested that Rule 3520 expressly require that auditors maintain independence from their audit client "both in fact and appearance." As proposed, the rule already requires auditors to maintain independence both in fact and appearance, because the SEC's independence rules—which are incorporated in Rule 3520, as discussed above—are "designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance."[27] In addition, Statement on Auditing Standard ("SAS") No. 1, Codification of Auditing Standards and Procedures, adopted by the Board as an interim standard, requires that auditors "not only be independent in fact; [but also] avoid situations that may lead outsiders to doubt their independence."[28] Therefore, the Board does not believe it is necessary to include this additional language in Rule 3520 to preserve these existing principles.

Some commenters also recommended that Rule 3520 expressly include the SEC's four overarching independence principles that it will look to in determining whether a particular service or client relationship impairs the auditor's independence.[29] Other commenters asked the Board to explicitly note in the rule that certain tax services are consistent with the SEC's four principles. For the reasons described above, the Board has decided not to change the rule in response to either of these suggestions. The Board notes, however, that the SEC's independence rules already refer to the four principles, and these rules must be complied with under Rule 3520.

Two commenters suggested that Rule 3520 include the text of the American Institute of Certified Public Accountants' ("AICPA") Ethics Rule 102, which provides, in pertinent part, that members of the AICPA should avoid any subordination of their judgment.[30] Although the Board shares these commenters' view about the importance of this principle, the Board has already adopted Ethics Rule 102 as part of its interim ethics rule, Rule 3500T. Accordingly, this rule is already part of the Board's ethical standards and need not be separately repeated in Rule 3520 to be enforced by the Board.

Two firms suggested that Rule 3520, as proposed, might have the effect of precluding use of exceptions in the SEC's existing independence rules and asked

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[27] 17 C.F.R. § 210.2-01, Preliminary Note 1; *accord United States v. Arthur Young & Co.*, 465 U.S. 805, 819 n.15 (1984).

[28] SAS No. 1, *Codification of Auditing Standards and Procedures*, paragraph .03 of AU sec. 220. The standard further states that "[p]ublic confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence." *Id*.

[29] *See* 17 C.F.R. §210.2-01, Preliminary Note 2. Specifically, under those principles, the SEC looks to whether a relationship or the provision of a service: (a) creates a mutual or conflicting interest between the accountant and the audit client; (b) places the accountant in the position of auditing his or her own work; (c) results in the accountant acting as management or an employee of the audit client; or (d) places the accountant in a position of being an advocate for the audit client.

[30] *See AICPA Code of Professional Conduct*, ET sec. 102, "Integrity and Objectivity".

the Board to avoid that result. Other than creating a requirement in a Board rule to comply with existing and applicable independence requirements, it does not add to, or detract from, the scope and substantive effect of these existing requirements in any respect.

The Board has, however, as suggested by a commenter, added "associated persons" to the rule. While the independence requirements added to the Board's rules through this rulemaking apply to the firm, other independence requirements covered by Rule 3520 are directed to individual accountants within auditing firms. Most notably, certain of the SEC's independence rules impose independence requirements directly on individual accountants.[31] Accordingly, the Board believes it is appropriate for the rule to apply to associated persons, as well as registered firms themselves. At the same time, the Board has added a new note to the rule to make clear that the rule applies only to those associated persons of a registered public accounting firm that are required to be independent of the firm's audit client by standards, rules, or regulations of the Commission or other applicable independence criteria.[32] Accordingly, the rule does not impose independence requirements on persons not already subject to them, and does not impose new independence requirements on any associated person. Rather, Rule 3520 only requires associated persons who are otherwise subject to independence requirements to comply, as an ethical obligation, with those requirements.

2. Contingent Fees

The Board also has determined to adopt Rule 3521 as proposed. There was widespread support among commenters for the Board's view, expressed in the proposal, that certain fee arrangements used for the provision of tax services create per se conflicts of interest that impair auditors' independence from their audit clients. As discussed more fully in the proposing release, when an accounting firm provides a service to an audit client for a contingent fee, the firm's economic interests become aligned with the interests of its audit client in a manner that is inconsistent with the firm's role as independent auditor. The Board's rule was adapted from the SEC's rule prohibiting contingent fee arrangements[33]and thus treats registered firms as not independent if they enter into contingent fee arrangements with audit clients.

Specifically, Rule 3521 provides that a registered public accounting firm is not independent of its audit client[34]if the firm, or any affiliate of the firm,[35] during the audit and professional engagement period,[36] provides any service or product to the audit client for a contingent fee or a commission, or receives from the audit client, directly or indirectly, a contingent fee or commission. The Board's

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[31] *See*, e.g., Rule 2-01(c)(1), 17 C.F.R. §210.2-01(c)(1). See *also* PCAOB Rule 3600T.

[32] Other applicable independence criteria include any rules of the PCAOB, other than Rule 3520, that contain independence requirements directly applicable to associated persons of the firm, such as Rule 3600T.

[33] *See* 17 C.F.R §210.2-01(c)(5).

[34] Rule 3501(a)(iv) defines "audit client" as "the entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client."

[35] Rule 3501(a)(ii) defines "affiliate of the accounting firm" as "the accounting firm's parents; subsidiaries; pension, retirement, investment or similar plans; and any associated entities of the firm, as that term is used in Rule 2-01 of the Commission's Regulation S-X, 17 C.F.R. §210.2-01(f)(2)."

[36] Rule 3501(a)(iii) adapts the definition of "audit and professional engagement period" from the definition of that term in Rule 2-01 of the SEC's Regulation S-X, which includes both the period covered by the financial statements under audit or review and the period beginning when a registered public accounting firm signs an initial engagement letter (or when such a firm begins audit, review or attest procedures, whichever is earlier) and ends when the audit client notifies the SEC that the engagement has ceased. *See* 17 C.F.R. §210.2-01(f)(5).

definition of a contingent fee is "any fee established for the sale of a product or the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service."[37]

Fees fixed by courts or other public authorities and not dependent on a finding or result are excluded from this definition to permit contingencies that do not pose a risk of establishing a mutual interest between the auditor and the audit client. In the proposing release, the Board cited, as an example of such a permissible fee, fees approved by a bankruptcy court, as required under U.S. federal bankruptcy law.[38] The Board also sought comment on whether there are courts or other public authorities that fix fees that are not dependent on a finding or result, other than bankruptcy courts, such that the term "courts or other public authorities" is necessary.

In response to this request, several commenters noted that they are not aware of any such authorities and encouraged the Board to eliminate the reference to "other public authorities" from the proposed rule. Other commenters suggested that the Board retain the phrase, even though they did not identify other contexts in which fees that are not contingent on a result of a "product or service" are nevertheless subject to approval by a court or other public authority.[39] After considering these comments, the Board has decided to retain the exception for fees that require approval of "courts or other public authorities." The Board envisions that there may be fee approval schemes outside the U.S. that are analogous to U.S. bankruptcy law.

Although Rule 3521 and the related definition of "contingent fee" are modeled on the SEC's independence rules, as discussed in the Board's proposing release, they differ from those rules in that the Board's rules do not include the SEC's exception for fees "in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies."[40] As discussed in the Board's proposing release, this exception may have been misinterpreted in the past and is largely redundant of the exception for fees fixed by courts or other public authorities.[41] For these reasons, proposed Rule 3521 would eliminate

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[37] Rule 3501(c)(ii). As discussed in the Board's proposing release, the term "contingent fee" includes the aggregate amount of compensation for a service, including any payment, service, or promise of other value, taking into account any rights to reimbursements, refunds, or other repayments that could modify the amount received in a manner that makes it contingent on a finding or result.

[38] 11 U.S.C. § 328(a) (providing that, with a court's approval, a bankruptcy trustee may employ a professional person "on any reasonable terms and conditions of employment, including on a retainer, on a fixed or percentage fee basis, or on a contingent fee basis").

[39] One commenter suggested that arbitration panels should be captured in the final rule as an example of "courts or other public authorities" that may approve auditor fees. The Board is not aware, and the commenter did not appear to suggest, that any arbitration panels currently have authority, by contract or law, to approve the payment of fees to accountants. Therefore, the Board has not expanded the exception to include fees fixed by arbitration panels. Nevertheless, if an arbitration panel were by contract given the authority to approve accountants' fees, such fees would be permissible under the Board's rule so long as the determination of the fee was not contingent on the result of a product or service.

[40] 17 C.F.R. § 210.2-01(f)(10). By eliminating this exception from its rule, the Board expresses no view on any firm's compliance with Rule 2-01 of the Commission's Regulation S-X. *See* 17 C.F.R. §210.2-01(c)(5).

[41] As the SEC Chief Accountant has stated, the SEC's "tax matters" exception only permits fee arrangements where the determination of the fee is "taken out of the hands of the accounting firm and its audit client . . ., with the result that the accounting firm and client are less likely to share a mutual financial interest in the outcome of the firm's advice or service." Letter from Donald T. Nicolaisen, Chief Accountant, U.S. Securities and Exchange Commission, to Bruce P. Webb, Professional Ethics Executive Committee Chair, American Institute of Certified Public Accountants (May 21, 2004), *available at* http://www.sec.gov/info/accountants/staffletters/webb052104.htm (hereinafter "Nicolaisen Letter").

this exception. The few commenters who addressed this issue agreed with the Board's reasoning and the elimination of this exception. Therefore, the Board's final rule does not include an exception for tax matters in which an auditor's fee agreement is based on the results of judicial proceedings or the findings of governmental agencies.

In addition, Rule 3521 treats a firm as not independent of an audit client if it receives a contingent fee or commission from that client "directly or indirectly." The rule's use of the term "indirectly" is meant to prevent arrangements for a fee from any person that is contingent on a finding or result attained by the audit client. The Board's determination to include such fees within the prohibition is based on the principle that, regardless of who pays the contingent fee, such a contingency gives an auditor a stake in the audit client attaining the finding or result. Accordingly, under Rule 3521, it does not matter who pays the contingent fee, if it is contingent on a finding or result attained by the audit client or otherwise related to the firm's services for the audit client. That is, while use of an intermediary to disguise an audit client's agreement to a contingent fee is certainly prohibited, the rule is not limited to circumstances in which a contingent fee may be traced (e.g., through an intermediary) to an agreement or payment by an audit client.

Comparable to the SEC's independence rules, proposed Rule 3521 treats contingent fee arrangements between a registered firm's affiliates and the registered firm's audit clients as relevant to the firm's independence.[42] The inclusion of such affiliates within the scope of those persons whose activities may impair the independence of a firm from an audit client is intended to prevent frustration of the rule's purpose through the use of firm subsidiaries and other affiliates.[43] The rule is not intended to, and does not, impose any requirements on affiliates of firms *per se*. Nonetheless, the conduct of an affiliate of the firm can cause the registered firm not to be independent in the situations specified in the rules.

Finally, one accounting firm commented that Rule 3521 should prohibit value-added fees because such fees could be used in lieu of contingent fees to achieve a similar effect as contingent fees. Fees that function as contingent fee arrangements are already prohibited under the SEC's rule against contingent

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[42] The rule does so by providing that the firm is not independent if it "or any affiliate of the firm . . . provides any service or product to the audit client for a contingent fee or a commission, or receives from the audit client, directly or indirectly, a contingent fee or commission." The scope of the rule is intended to be the same as the scope of the Commission's rule, which defines the terms "accountant" and "accounting firm" to include such affiliates. Because registration with the Board is the basis for the Board's authority over an accountant, the rules would treat those persons that are related to a registered public accounting firm and satisfy the Commission's definition of "accounting firm," but are not registered firms themselves, as "affiliates of the accounting firm." Thus, Rule 3501(a)(i) would adapt the Commission's definition of the term "accounting firm" to define the term "affiliate of the accounting firm" as "the accounting firm's parents, subsidiaries, pension, retirement, investment or similar plans, and any associated entities of the firm, as that term is used in Rule 2-01 of the Commission's Regulation S-X, 17 C.F.R. §210.2-01(f)(2)."

[43] *See*, e.g., *In re PricewaterhouseCoopers LLP, & PricewaterhouseCoopers Securities LLC*, Exchange Act Release No. 46,216 (July 17, 2002), *available at* http://www.sec.gov/litigation/admin/34-46216.htm (finding an auditing firm and an affiliate under the control of the firm in violation of Commission requirements because the affiliate performed investment banking services for the firm's audit clients for contingent fees); In *KPMG, LLP v. Securities & Exch. Comm'n*, 289 F.3d 109 (D.C. Cir. 2002), the D.C. Circuit Court declined to find KPMG in violation of the AICPA's rule against contingent fees, where KPMG only indirectly received a contingent royalty from an audit client, through an associated entity of the firm. The Board's rules should be understood, however, to treat such an arrangement as an impairment of a registered firm's independence.

fees,[44] and thus under the Board's final rule as well, whether such fees are labeled contingent fees, value-added fees, or otherwise. The SEC has indicated that it will closely monitor the use of valueadded fees "to determine whether a fee labeled a "value added" fee is in fact a contingent fee, such as where there are side letters or other evidence that ties the fee to the success of the services rendered,"[45] and the Board intends to do so as well before, if necessary, considering additional rulemaking.

3. Aggressive Tax Positions

Rule 3522 is intended to describe a class of tax-motivated transactions that present an unacceptable risk of impairing an auditor's independence if the auditor markets, plans, or opines in favor of, such a transaction. As discussed in the Board's proposing release, such conduct has seriously damaged investors' confidence in the judgment, objectivity, and ethics of firms that engage in such transactions. Further, aggressive tax positions carry a high risk that taxing authorities will not allow the position taken by the auditor and the audit client. As the SEC Chief Accountant noted in the context of contingent fees, "the fact that a government agency might challenge the amount of the client's tax savings . . . heightens . . . the mutuality of interest between the firm and client."[46]

As proposed, Rule 3522 treated a firm as not independent of its audit client if the firm, or an affiliate of the firm, provided services related to planning, or opining on the tax consequences of a transaction that is a listed or confidential transaction under U.S. Department of Treasury ("Treasury") regulations or that promoted an interpretation of applicable tax laws for which there is inadequate support. In order to describe such transactions in a manner that is clear and consistent with existing constructs for analyzing tax-oriented transactions, the rule is adapted from certain Treasury regulations and from the SEC's release accompanying its 2003 independence rules.

Commenters generally supported the notion that auditors should not provide tax services involving aggressive tax positions to their audit clients. They also supported the scope of Rule 3522, which as proposed covered listed transactions, confidential transactions, and other aggressive transactions. A number of commenters made suggestions to make the rule text clearer, however, and after considering such comments the Board has modified the rule in several respects.

First, several commenters suggested that the rule should make clear that it does not prohibit auditors from advising audit clients *not* to engage in an aggressive transaction. Rule 3522 was not intended to prevent such advice, so in response to these comments the Board has modified the rule to make clear the prohibition on opining on aggressive transactions is limited to "opining *in favor of* the tax treatment of" such transactions (emphasis added). Thus, auditors are permitted

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[44] *See* Revision of the Commission's Auditor Independence Requirements, SEC Release No. 33-7919, §IV.D.5 (Nov. 21, 2000), 17 C.F.R. Parts 210, 240. Indeed, the SEC staff has cautioned audit committees against approving—

> any agreement—from a direct contract provision to "a wink and a nod"—that provides for the possible additional payment of a "value added" fee based on the results of an accounting firm's performance of a tax or other service [that] would be viewed as impairing the firm's independence. In addition, an audit committee should consider carefully the impact on an accounting firm's independence of the possibility of even a completely voluntary payment of a "value added" fee by an audit client to the firm.

Nicolaisen Letter, *supra* note 41.

[45] *See* Revision of the Commission's Auditor Independence Requirements, SEC Release No. 33-7919, §IV.D.5 (Nov. 21, 2000), 17 C.F.R. 210, 240.

[46] Nicolaisen Letter, *supra* 41.

to advise *against* an audit client's execution of an aggressive tax transaction.[47] However, Rule 3522 prohibits an opinion that a transaction does not satisfy the more-likely-than-not standard but does satisfy a lower standard of confidence. Similarly, the rule prohibits advice that an audit client will "probably" lose an argument in favor of a tax treatment, because such advice can imply up to a 49-percent chance of success.

In addition, as recommended by one commenter, given recent concerns about accounting firms establishing marketing centers to sell tax shelter products, the Board has added the term "marketing" to the list of activities that compromise an auditor's independence. That is, under Rule 3522, as adopted, an auditor may not market an aggressive tax transaction to an audit client, in addition to being prohibited from "planning, or opining in favor of the tax treatment of," such a transaction.

Finally, proposed Rule 3522(a)'s prohibition on auditors' involvement in listed transactions has been moved to become a part of the prohibition on involvement in aggressive tax position transactions, in light of the overlap of the two provisions and also in light of questions regarding whether the prohibition on listed transactions could apply in the context of a non-U.S. tax regime. Accordingly, Rule 3522 now provides for two categories of prohibitions related to aggressive tax transactions, whereas, as proposed, it had provided for three such categories. These two categories, as well as modifications of their proposed versions, are discussed below.

a. Aggressive Tax Position Transactions[48]

Rule 3522(b) would treat a registered firm as not independent if the firm, or an affiliate of the firm, provided an audit client any service related to marketing, planning, or opining in favor of the tax treatment of, a transaction that satisfies three criteria—

- the transaction was initially recommended, directly or indirectly, by the firm;
- a significant purpose of the transaction is tax avoidance; and
- the proposed tax treatment of the transaction is not at least more likely than not to be allowed under applicable tax laws.

Rule 3522(b) is adapted from the SEC's guidance to audit committees in its release accompanying its 2003 independence rules, which cautioned that audit committees should "scrutinize carefully" the retention of the auditor "in a transaction initially recommended by the accountant, the sole business purpose of which may be tax avoidance and the tax treatment of which may be not supported in the Internal Revenue Code and related regulations."[49] The rule builds on this guidance from the perspective of the auditor, by providing that a

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[47] In addition, a number of commenters asked for clarification of the scope of Rule 3522's prohibition against "opining" on an aggressive transaction. The Board does not intend the rule to encompass the auditor's opinion on the fairness of financial statements that reflect the accounting for a transaction that an audit client has executed. Rather, Rule 3522 is intended to prevent auditors from facilitating clients' execution of aggressive transactions by, among other things, providing auditors' written tax opinions that protect the audit client from the assertion of penalties by tax authorities or courts.

[48] As proposed, this provision was entitled "aggressive tax positions." One commenter questioned whether this title was intended to expand the scope of this provision beyond transactions. In addition, the commenter noted that the term "transaction" was consistent with Treasury regulations. In response to this comment, the Board has re-titled this provision to be "aggressive tax position transactions."

[49] Strengthening the Commission's Requirements Regarding Auditor Independence, *supra* note 2, at §II.B.11 (Jan. 28, 2003).

registered firm is not independent of its audit client if the firm, or an affiliate of the firm, participates in such a transaction.

The first prong of the rule's test looks for transactions that the auditing firm—directly or indirectly, e.g., through an affiliate, through or with another tax advisor with which the firm has an arrangement, or otherwise—initially recommended to the audit client. In this manner, the rule excludes from its scope those transactions that the audit client itself, or a party other than a tax advisor with which the firm has an arrangement[50](e.g., an acquiring corporation), initiated. The term "initially recommended" is intended to be a test based on fact. Thus, the prong would be satisfied, notwithstanding a representation from the audit client that the audit client initiated the development of the transaction,[51] if the auditor had knowledge that the auditor, its affiliate, or another tax advisor with which the firm has an arrangement, initially recommended it. As proposed, the rule would have looked for transactions that were "initially recommended by the registered public accounting firm or another tax advisor." Some commenters expressed concern that an auditor might not be in a position to know whether another tax advisor with no relationship to the auditor had recommended a transaction. In response to these comments, the Board has modified the first prong of Rule 3522(b) to make clear that auditors are only responsible for ascertaining whether the firm, one of its affiliates, or another tax advisor with which the firm has a formal agreement or other arrangement related to the promotion of such a transaction, initially recommended the transaction.[52]

The second and third prongs of Rule 3522(b) incorporate concepts that have existing meaning and relevance to tax advisors. The second prong of the test set forth in Rule 3522(b) uses the phrase "significant purpose of which is tax avoidance," adapted from the Internal Revenue Code.[53] The term "tax avoidance" should be understood to include acceleration of deductions into earlier taxable years and deferral of income to later taxable years. A few commenters noted that the test whether a significant purpose of a transaction is tax avoidance appears to be a low threshold that could encompass any plan to reduce taxes, and some of those commenters suggested that the Board raise that threshold. The Board intends for the threshold to be low, however, and therefore has not used terms that might seem to establish a higher threshold, such as requiring an evaluation of whether the "sole purpose" of a transaction is tax avoidance.

In addition, the rule uses the term "more likely than not to be allowable under applicable tax laws," which is the standard certain taxpayers must meet, under Treasury regulations, to avoid penalties for substantial understatement

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[50] The term "tax advisor" is not intended to denote a group with a certain license or professional status, but rather to cover any person, other than the client, that recommends a tax transaction to the client.

[51] Two commenters indicated that, as they interpreted the term "transaction," an auditor's tax services in connection with, for example, a merger transaction that was initiated by the client or another company, would not come within the ambit of Rule 3522(b), because the auditor would not have recommended the merger transaction itself. This is not a fair interpretation of the rule and indeed would thwart its purpose.

[52] *See* Rule 3522(b), Note 2. The term "formal agreement or other arrangement" in Note 2 relates only to relationships a registered firm may have with a tax advisor that is not already an affiliate of the firm.

[53] The Internal Revenue Code treats transactions with respect to which a "significant purpose . . . is the avoidance or evasion of Federal income tax" as tax shelters, for purposes of determining whether an adequate disclosure defense is available for the substantial understatement penalty. *See* 26 U.S.C. §6662(d)(2)(C) (amended by the Jobs Act; *see also* 26 U.S.C. §6662A(b)(2)(B) (imposing 20-percent penalty on understatements of tax in connection with "any reportable transaction (other than a listed transaction) if a significant purpose of such transaction is the avoidance or evasion of Federal income tax").

of income tax in connection with a tax shelter.[54] This test is based, in part, on the Board's observation of some firms' policies that rely on the "more likely than not" standard to approve the firm's involvement in providing tax services relating to a transaction initiated by the firm. The rule also uses this standard because a tax treatment that is not "more likely than not" to be allowed poses a significantly higher risk of being challenged by taxing authorities, such that a mutuality of interest between the auditor and the audit client could arise.[55] Moreover, the rule uses this standard, as opposed to a higher standard, in recognition of the fact that tax laws may often be complex and subject to differing good faith interpretations.[56]

In order to satisfy Rule 3522(b)'s "more likely than not" standard, a registered public accounting firm must establish, based on an analysis of the pertinent facts and authorities, that there is a greater than 50-percent likelihood that the tax treatment of the transaction would, if challenged, be upheld.[57] To satisfy this test, an auditor's analysis must be objectively reasonable and well-founded at the time the analysis is conducted. The Board would not, however, treat an auditor as not independent if the law changed after the service was provided or if the tax treatment simply turned out to be not allowed, despite the auditor's reasonable judgment before the ultimate resolution of a tax claim or other dispute.

Rule 3522(b) does not require a registered public accounting firm to obtain a third-party opinion that a tax treatment is "more likely than not" to be allowed under applicable tax laws. On the contrary, while a firm may decide for its own reasons to obtain a third-party opinion, such an opinion would not relieve the firm of its obligation to form its own judgment on the likelihood of a proposed tax treatment to be allowed.[58]

Finally, although the SEC's release accompanying its 2003 independence rules cautioned audit committees to scrutinize situations in which a proposed tax treatment might not be supported "in the Internal Revenue Code and related

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[54] *See* 26 C.F.R. §1.6664-4(f).

[55] Some commenters noted that, while the term "more likely than not" is wellunderstood in the context of evaluating U.S. tax advice, it has not been used in non- U.S. contexts. One of these commenters also noted that this standard may be hard to judge in jurisdictions in which the rule of law does not always prevail. After considering these comments, the Board has determined to maintain the "more likely than not standard," because it is an objective standard that may be applied in contexts outside the U.S. even where it has not applied to-date. Further, the Board notes that foreign private issuers ordinarily file U.S. tax returns and therefore are already expected to comply—and be familiar with—U.S. tax laws and regulations.

[56] A few commenters recommended that the Board use a standard higher than "more likely than not," on the ground that there is some evidence that some accounting firms that used the "more likely than not" standard in the past have not adhered to it. While the Board is concerned about the record on this issue, the Board has determined not to use a higher standard at this time. The Board intends to monitor compliance with the rule through its inspections of registered public accounting firms and will consider revising the rule in the future, if that monitoring or other evidence reveals that the rule is not achieving its intended purpose.

[57] Cf. 26 C.F.R. §1.6664-4(f)(2)(i)(B)(1) (incorporating by reference methodology set forth in 26 C.F.R. §1.6662-4(d)(3)(ii) for analysis of whether a tax treatment has "substantial authority" or, in the case of tax shelters, is "more likely than not" the proper treatment, for purposes of determining whether a penalty may be due on a substantial understatement of income tax).

[58] Treasury regulations permit corporations to avoid penalties for substantial understatement of income taxes in connection with tax shelters if they "reasonably rel[y] in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities . . . and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service." 26 C.F.R. § 1.6664-4(f)(2)(i)(B)(2). Rule 3522(b) would not permit registered public accounting firms, who themselves serve as tax advisors, to rely on other tax advisors to satisfy the rule's standard because registered firms that provide tax services are themselves in a position to perform such an analysis.

regulations," the proposed rule would use the term "applicable tax laws" in recognition of the variety of tax laws and regulations, including federal, state, local, foreign, and other tax laws, that may be the subject of tax services. For this reason, and in response to questions from several commenters, the Board also incorporated its proposed prohibition on auditors providing tax services in connection with transactions that are listed by the IRS into Rule 3522(b). That is, IRS listing is one example of aggressive tax transactions covered by the rule.

Accordingly, the prohibition on advising in favor of listed transactions, which was proposed as Rule 3522(a), has been moved to a note to what is now Rule 3522(b). Specifically, Note 1 to Rule 3522(b) treats a registered public accounting firm as not independent of its audit client if the firm, or any affiliate of the firm, provided services related to marketing, planning, or opining in favor of the tax treatment of, a listed transaction. Under Treasury regulations, a listed transaction is "a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction."[59] The IRS uses its listing process to identify and publish a list of transactions that tax promoters and advisors have developed and sold to clients but that, in the IRS's view, do not comply with applicable laws. Thus, the Treasury's regulation on "listed transactions" identifies a class of transactions that, in the Board's view, carries an unacceptable risk of disallowance, which in turn create an unacceptable risk of establishing a mutuality of interest between the auditor and the audit client if the auditor participated in marketing, planning, or opining in favor of the tax treatment of a transaction that impairs independence. By referring to this class of transactions, Note 1 to Rule 3522(b) incorporates an existing framework that auditors who serve as tax advisors already follow in their tax practices and that is highly likely to remain current since the Treasury and the IRS regularly update guidance related to listed transactions.[60]

As discussed above, the Board's proposed prohibition on auditor involvement in transactions that are "listed" by the IRS has been moved to a note to Rule 3522(b). By definition, a listed transaction is not "more likely than not to be allowable under applicable tax laws" at the time the auditor advises on it. Because the risk of IRS or other scrutiny of listed transactions, including transactions that are substantially similar to listed transactions,[61] is high, tax advisors and taxpayers tend not to enter into such transactions once they are listed. In light of this fact, when it proposed this rule, the Board sought comment on whether the rule should treat an auditor as not independent if a transaction planned or opined on by the auditor subsequently became listed. In general, commenters recommended against adopting a *per se* rule that subsequent listing of such a transaction impaired an auditor's independence with respect to either the period in which the transaction was executed or in subsequent periods. The Board

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[59] *See*, e.g., 26 C.F.R. §1.6011-4(b)(2).

[60] The IRS updates the list of listed transactions by issuing a listing notice, both adding to and removing transactions from the list of listed transactions. *See*, *e.g.*, IRS Notice No. 2004-67, 2004-41 I.R.B. 600. Some commenters questioned whether the Board should effectively incorporate the IRS's changes to its list into the Board's rule on aggressive transactions. This is, indeed, the Board's intention. To freeze the IRS's list as of the date of the Board's final rule, or to establish a system of reviewing the IRS's list as it is updated, might permit auditors to provide tax services in favor of listed transactions notwithstanding that the IRS had identified those transactions as potentially abusive. Such a system would thwart the underlying intent of the Board's rule.

[61] By its terms, the Treasury regulation requiring reporting of listed transactions makes clear that the definition of "listed transaction" includes transactions that have been listed by the IRS as well as transactions that are "substantially similar" to such transactions. By expressly referring to the Treasury's regulation on listed transactions, the Board intends Rule 3522(b) to encompass such substantially similar transactions that are included in the Treasury's regulation.

agrees that such a *per se* rule would not be appropriate, but as discussed below, firms should nevertheless be cautious in participating in transactions that they believe could become listed.

Even if a firm were independent at the time a transaction was executed, because it reasonably and correctly concluded the transaction was not the same as, or substantially similar to, a listed transaction, once a transaction is actually listed (or a substantially similar transaction becomes listed), a firm that has participated in the transaction may find its independence impaired due to the mutuality of interest caused by the listing. That is, depending on the circumstances, a firm's independence may become impaired in some cases after a transaction planned or opined on by the firm becomes listed. In such cases, the auditor should carefully consider the potential impairment of its independence with the audit committee of its audit client.[62] For example, once a transaction is listed, either the audit client or the firm, or both, may be required to defend the tax treatment of the transaction and, in some cases, pay penalties. In addition, the firm may face liability to the audit client related to the firm's tax advice. The auditor's judgment regarding appropriate financial reporting and disclosure concerning a transaction that becomes listed could become biased by the auditor's vested interests in defending its tax advice.

Some auditors commented that they would prefer a bright-line rule providing that, so long as a transaction recommended by the firm was not listed at the time it was executed, subsequent listing cannot impair an auditor's independence later in time, when the auditor is called on to defend its earlier tax advice. Such a bright-line rule, however, would do little to address circumstances in which, because of IRS scrutiny after execution of the transaction, the auditor's interest in the client's successful defense of the transaction becomes heightened to the point where the auditor can no longer be impartial about the financial statement presentation of the transaction. That said, as some commenters noted, existing independence requirements address these kinds of circumstances, and thus the Board has determined not to expand Rule 3522(b) either to retroactively deem an auditor not independent upon subsequent listing of a transaction or to deem an auditor not independent *per se* in the period in which such a transaction becomes listed.

b. Confidential Transactions

The Treasury has identified transactions with tax-advisor imposed conditions of confidentiality as potentially abusive. By regulation, the Treasury requires taxpayers to disclose to the IRS transactions in which a tax advisor "places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies."[63] Tax-advisor imposed confidentiality may also be indicative of a tax product that a tax advisor intends to market to multiple customers, thus necessitating commitments by customers to treat the tax treatment or structure of the advisor's product as confidential.

As discussed in the proposing release, the Board is concerned that marketing, planning, or opining in favor of tax products that require confidentiality in order that they may be offered to multiple clients contributes to the erosion of public confidence in the ethics and integrity of such firms. A reasonable investor easily

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[62] According to ISB Standard No. 1, which is incorporated in the Board's Rule 3600T interim independence standards, at least annually, an auditor must "disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence."

[63] 26 C.F.R. § 1.6011-4(b)(3)(ii).

could infer that the auditor has a vested interest in advocating to the IRS the tax treatment it promoted, or helped to promote, to multiple clients and perpetuating that treatment in the audit client's financial statements. Based on these concerns, Rule 3522(a) treats a registered public accounting firm as not independent of its audit client if the firm, or an affiliate of the firm, provided services related to marketing, planning, or opining in favor of the tax treatment of a transaction for an audit client under terms that satisfy the definition of "confidential transaction," as defined by Rule 3501(c)(i), which is adapted from the Treasury's regulation requiring tax advisors to report confidential transactions.[64]

It should be noted that, Rule 3501(c)(i) defines confidential transactions in terms of confidentiality restrictions imposed by tax advisors generally, not specifically auditors. Therefore, whereas under Rule 3522(b) a transaction that is initially recommended by a tax advisor other than the auditor or an affiliate of the auditor unless the tax advisor has an arrangement with the auditor does not fall within the first prong of the rule, Rule 3522(a) prohibits an auditor from marketing, planning, or opining in favor of a confidential transaction whether the applicable terms of confidentiality are imposed by the auditor or by another tax advisor, acting independently of the auditor.

Commenters generally supported the Board's proposed prohibition on confidential transactions. Although some commenters expressed the view that tax advisors might impose conditions of confidentiality for reasons other than the ability to market the proposed transaction to multiple clients, other commenters agreed that auditors should not become involved in transactions subject to tax-advisor imposed confidentiality restrictions. One accounting firm commenter also noted that, even if a transaction were not potentially abusive, the fact that there is a disclosure limitation is likely to create a negative impression concerning the objectivity of the auditor.

In addition, a few commenters suggested that the rule be limited to circumstances in which terms of confidentiality are imposed with respect to the U.S. tax treatment of a transaction. After carefully considering these comments, the Board has determined not to modify the scope of the rule. Tax-advisor imposed conditions of confidentiality facilitate aggressive selling of novel tax ideas that pose too great a risk of impairing the objectivity of auditors who market, plan, or opine in favor of them. Further, the rule continues to permit audit clients themselves to impose conditions of confidentiality in connection with transactions

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[64] 26 C.F.R. § 1.6011-4(b)(3) (2005). The proposed version of this rule incorporated the Treasury's definition of the term "confidential transaction" by reference. A number of commenters noted generally that incorporation of this Treasury regulation by reference could lead to unintended changes to the Board's rules if the Treasury amends those regulations (or the IRS amends its list of listed transactions). As discussed above, the Board intends for its prohibition on auditors' involvement as tax advisors in audit clients' execution of listed transactions to be kept current by changes to the IRS's list. Upon further consideration, unlike the Board's prohibition on listed transactions, the Board has determined that it may not be appropriate for any changes the Treasury may make to its definition of "confidential transaction" to automatically be reflected in the Board's prohibition on auditors' involvement in such a transaction. The definition of "confidential transaction" in Rule 3501(c)(i) is intended to be the same as the current Treasury regulation, except for the minimum fee requirement.The proposed version of the rule did not incorporate the Treasury's minimum fee exception to its regulation on confidential transactions. That is, Treasury Regulation 1.6011-4(b)(3)(i) provides that "a confidential transaction is a transaction that is offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a minimum fee." 26 C.F.R. § 1.6011-4(b)(3) (2005). Under the regulation, the "minimum fee" is $250,000 for corporate taxpayers (and partnerships and trusts in which all of the owners or beneficiaries are corporations) and $50,000 for all other transactions. *Id*. 26 C.F.R. §1.6011-4(b)(3)(iii). Although some commenters suggested that the Board should adopt the minimum fee exception, the Board understands the IRS disclosure rules to serve a different purpose than Rule 3522(a). Accordingly, the Board has not adopted a minimum fee exception in its final rule either.

on which auditors may provide tax advice, and this fact appears to adequately serve audit clients' needs to maintain appropriate confidentiality. Finally, there does not appear to be a reasoned basis to limit the prohibition on confidential transactions to proposed tax treatments under U.S. tax laws.

4. Tax Services for Persons in Financial Reporting Oversight Roles

Rule 3523 provides that a registered public accounting firm is not independent of an audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any tax service to a member of management in a financial reporting oversight role at the audit client.[65] As discussed in the Board's proposing release, this rule addresses concerns that performing tax services for certain individuals involved in the financial reporting processes of an audit client creates an appearance of a mutual interest between the auditor and those individuals.

The Board received varied comments on Rule 3523. Some commenters, including groups representing investors and issuers, as well as several large accounting firms, supported the proposed rule on the ground that it is necessary to preserve the objectivity, and the appearance of objectivity, of auditors. Other commenters, however, including a number of smaller accounting firms, accounting associations, and a few issuers, claimed that the rule is not necessary, that these services have long been provided, and that auditors should be allowed to provide senior financial management of issuers with the same types of tax services the auditor may provide the issuer. After carefully considering these comments, the Board has determined to adopt the rule, with a few modifications. The Board continues to believe that the provision of tax services by the auditor to the senior management responsible for the audit client's financial reporting creates an unacceptable appearance of the auditor and such senior management having a mutual interest.

The Board also received a number of comments on specific aspects of the proposed rule. For example, some commenters expressed confusion as to whether Rule 3523 is intended to apply to directors, in part because the definition of "financial reporting oversight role" includes directors. In response to these comments, the Board has modified the rule to exclude directors more explicitly. Thus, the rule no longer uses the term "officer"—which is how the proposed rule narrowed the scope to exclude directors—and instead includes an explicit exception for any person who serves in a financial reporting oversight role "only because he or she serves as a member of the board of directors or similar management or governing body of the audit client."[66]

The Board also included a second exception in Rule 3523(b) in response to comments regarding whether the rule should apply to persons who serve in a financial reporting oversight role at an affiliate of an issuer. After considering these comments, the Board has determined not to restrict auditors' provision of tax services to employees in a financial reporting oversight role at an affiliate

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[65] The rule's use of the term "financial reporting oversight role" is based on the Commission's definition of "financial reporting oversight role," which includes any person who has direct responsibility for oversight over those who prepare the issuer's financial statements and related information (for example, management's discussion and analysis) that are included in filings with the Commission. *See* Strengthening the Commission's Requirements Regarding Auditor Independence, *supra* note 2, at §II.A. The Commission uses the term "financial reporting oversight role" to describe those positions that are covered by the Act's "cooling off" period, during which a public company would not be independent from its audit firm if a member of the engagement team for the audit of that company assumed such a position. *See* Sarbanes-Oxley Act of 2002, §206, 17 C.F.R. §210.2-01(f)(3)(ii). The term "financial reporting oversight role" as defined in Rule 3501(f)(i) mirrors verbatim the SEC's definition of the same term in Rule 2-01 of Regulation S-X. 17 C.F.R. §210.2-01(f)(3)(ii).

[66] Rule 3523(a).

of an audit client, so long as the financial statements of the affiliate are not material to the financial statements of the audit client or are audited by an auditor other than the firm or an associated person of the firm. This exception is intended to exclude executives of affiliates that do not contribute to the consolidated financial statements of the audit client. The Board does not believe that auditors' relationships with executives of immaterial affiliates, or affiliates whose financial statements are audited by an auditor other than the firm or an associated person of the firm, pose as great a risk to auditors' impartiality regarding an audit clients' consolidated financial statements as do auditors' provision of tax services to executives involved in the consolidated financial reporting of the client.

The first part of this exception, Rule 3523(b)(i), excludes persons in a financial reporting oversight role at immaterial affiliates of the entity being audited. This exception would encompass, among others, executives of most affiliates within the same investment company complex as the audited entity and executives of up-stream affiliates of the audited entity. The second part of this exception, Rule 3523(b)(ii), excludes executives in financial reporting oversight roles of a subsidiary of an audit client that is not audited by the firm or any firm that is an associated person of the firm, as defined by PCAOB Rule 1001. On the other hand, executives in financial reporting oversight roles at a material subsidiary whose financial statements are audited by a firm that is an associated person of the registered firm would be subject to Rule 3523. For purposes of Rule 3523(b)(ii), the term "audited" should be understood to include audit procedures that contribute to the firm's preparation or issuance of an audit report on an audit client's consolidated financial statements, whether or not such procedures result in an audit opinion on the affiliate's financial statements.

Some commenters also expressed concern that the rule could impose an undue hardship on persons who become subject to the rule because they are hired or promoted into a financial reporting oversight role at an audit client. To address that concern, the Board determined to create a time-limited exception to the rule to cover such situations. Specifically, the Board has determined to add a new exception to the rule that applies to a person who was not in a financial reporting oversight role at the audit client before a hiring, promotion, or other change in employment event, when the tax services are both: (1) provided pursuant to an engagement that was in process before the hiring, promotion, or other change in employment event; and (2) completed on or before 180 days after the hiring or promotion event.[67] The Board will treat engagements as "in process" if an engagement letter has been executed and substantive work on the engagement has commenced; the Board will not treat engagements as "in process" during negotiations on the scope and fee for a service.

Some commenters also suggested that, as proposed, Rule 3523 could invite persons subject to the rule to evade the rule by using the auditor's tax services through an immediate family member or through an entity controlled by the person. In response to this comment, the Board has added to the scope of the rule immediate family members of persons who are covered by the rule.[68]

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[67] Rule 3523(c).

[68] The Board also has added a definition of "immediate family member," adapted from the SEC's definition in its independence rules. *Compare* Rule 3501(i)(i) *with* 17 C.F.R. §210.2-01(f)(13). The Board has not included entities controlled by persons in financial reporting oversight roles, such as trusts and investment partnerships. The Board notes, however, that an auditor who provides services to an entity controlled by a person in a financial reporting oversight role of an audit client should consider whether, under ISB Standard No. 1, it is necessary to notify the client's audit committee of such services.

In addition, some commenters suggested that the rule be expanded to cover all non-audit services, such as services involving investment, personal financial planning, and executive compensation, on the ground that any such services provided to those in a financial reporting oversight role create a perception of a mutuality of interest between auditors and those members of management who receive such services.[69] Other commenters suggested that the rule be expanded to include persons who do not play a financial reporting oversight role but nevertheless play a key role in operations, such as vice presidents of sales.[70] Other commenters recommended the rule cover audit committee members. Still other commenters, however, disagreed with these commenters and noted that applying the rule to audit committee members might serve as a practical disincentive to audit committee service.

The Board has determined not to expand the final rule to include all non-audit services, directors or persons outside the definition of "financial reporting oversight role." To date, the concerns that have arisen in this area have related to auditors' provision of tax services to executives of public companies. Accordingly, the Board believes it is appropriate, at this time, to limit the rule to address this problem. The Board intends to monitor implementation of the rule, however. In addition, to the extent that issuers pay for non-audit services provided to any individuals, audit committees can and should be scrutinizing the potential effects on the auditor's independence due to such services. Further, as discussed in the proposing release, although accounting firms are not now required to seek pre-approval for executive tax services paid directly by the employee, auditors should consider under Independence Standards Board ("ISB") Standard No. 1 whether it is necessary to notify the audit committee of these services[71] or whether it is otherwise advisable to inform audit committees of such services.[72] In this regard, while the Board is reluctant to establish a per se prohibition on auditors' provision of tax services to directors of their audit clients, the Board notes that firms can – and some have – adopted procedures

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[69] Some commenters asked for clarification of whether persons in a financial reporting oversight role could seek the assistance of the registered public accounting firm that prepared the original tax return to assist them in responding to an IRS or other governmental agency examination regarding that specific tax return after Rule 3523 becomes effective. If a registered firm prepared such a tax return before the rule's effective date, the rule does not operate to prohibit that person from answering questions and providing assistance when that tax return is under examination by a taxing authority after the rule's effective date, Such assistance, of course, must be otherwise consistent with Board and SEC auditor independence rules, including the requirement the auditor not become an advocate for its audit client.

[70] A few commenters suggested that the Board use the list of officers in section 16 of the Exchange Act, rather than relying on the defined term "financial reporting oversight role." The "financial reporting oversight role" term, however, includes those individuals at an audit client that, because of their oversight of the company's financial reporting process, raise special concerns when they have certain relationships with the auditor. For this reason, the Board continues to believe this is the appropriate group to include in this rule.

[71] *See* ISB Standard No. 1; *see also* Memorandum from Scott A. Taub, Deputy Chief Accountant, Office of the Chief Accountant, U.S. Securities and Exchange Commission to William H. Donaldson, Chairman, Securities and Exchange Commission at 5 (June 24, 2003) (attached to letter from Chairman William H. Donaldson, U.S. Securities and Exchange Commission, to Five Consumer Groups) (July 11, 2003), *available at* http://www.sec.gov/info/accountants/staffletters/taub071103.pdf (hereinafter "Taub Memo").

[72] For example, the SEC staff has recommended that audit committees scrutinize audit firms' provision of these services—

> The provision of tax services to the executives of an audit client is not expressly addressed in the Act or in the Commission's rules. Nonetheless, an audit committee should review the provision of those services to assure that reasonable investors would conclude that the auditor, when providing such services, is capable of exercising objective and impartial judgment on all issues within the audit engagement.

Taub Memo, *supra* note 71, at 5.

to notify the audit committee of such services so it may evaluate the potential effect of such services on the auditor's independence.[73]

C. The Auditor's Responsibilities in Connection With Audit Committee Preapproval of Tax Services

Under Section 10A(h) of the Exchange Act, as amended by Section 202 of the Sarbanes-Oxley Act, all non-audit services that the auditor proposes to perform for an issuer client "shall be pre-approved by the audit committee of the issuer." The SEC's 2003 independence rules implemented the Act's pre-approval requirement by adopting a provision on audit committee administration of the engagement.[74] Rule 3524 implements the Act's pre-approval requirement further by strengthening the auditor's responsibilities in seeking audit committee pre-approval of tax services. Specifically, Rule 3524 requires a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee[75] to perform tax services that are not otherwise prohibited by the Act or the rules of the SEC or the Board to—

- Describe, in writing, to the audit committee the nature and scope of the proposed tax service;
- Discuss with the audit committee the potential effects on the firm's independence that could be caused by the firm's performance of the proposed tax service; and
- Document the firm's discussion with the audit committee.

These requirements are intended to buttress the pre-approval processes established by the Act and the Commission's rules. Whether an audit committee preapproves a non-audit service on an *ad hoc* basis or on the basis of policies and procedures, the Commission staff has stated that "detailed backup documentation that spells out the terms of each non-audit service to be provided by the auditor" should be provided to the audit committee.[76] Indeed, the SEC staff has indicated "[s]uch documentation should be so detailed that there should never be any doubt as to whether any particular service was brought to the

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[73] *See*, e.g., Remarks of Scott Bayless, Deloitte & Touche LLP, *Auditor Independence Roundtable on Tax Services* (July 14, 2004) at 152 (indicating that even when "the company does not pay for those services . . . there is a notification procedure to ensure that the audit committee has the ability to take control of that relationship if they so desire").

[74] *See* 17 C.F.R. §210.2-01(c)(7).

[75] Proposed Rule 3524 used the term "audit committee of the audit client," which some commenters interpreted to mean that the rule would require auditors to make the required communications in connection with proposed tax services for affiliates of an audit client that are not consolidated as subsidiaries with the audit client for financial statement purposes. One commenter noted that the Commission's Rule 2- 01(c)(7) requires only that "[b]efore the accountant is engaged by the issuer or its subsidiaries, or the registered investment company or its subsidiaries, to render audit or non-audit services, the engagement [be] approved by the issuer's or registered investment company's audit committee." By using the phrase "in connection with seeking audit committee pre-approval," the Board intends Rule 3524 to apply only when the SEC's Rule 2-01(c)(7) requires such approval. Accordingly, the rule does not require registered firms to make the specified communications or to seek audit committee pre-approval in any situations in which audit committee pre-approval is not already required by the SEC's rules. Nor should the rule be understood to require preapproval by any committee other than the committee required to provide pre-approval by the SEC's rules. To clarify this issue, the Board has also modified Rule 3524 to more clearly track the language of section 10A(h) of the Exchange Act and the SEC's Rule 2- 01(c)(7).

[76] Taub Memo, *supra* note 71, at 3; *see also* SEC Office of the Chief Accountant: Application of Commission's Rules on Auditor Independence Frequently Asked Questions, Audit Committee Preapproval, Question 5, (issued August 13, 2003), *available at* http://www.sec.gov/info/accountants/ocafaqaudind121304.htm (hereinafter "FAQs").

audit committee's attention and was considered and pre-approved by that committee."[77]

Rule 3524 implements the Act's pre-approval requirement further by requiring that registered firms provide the audit committee of an issuer audit client a description of proposed tax services engagements that includes descriptions of the scope of any tax service under review and the fee structure for the engagement.[78] Some commenters suggested significant changes to the scope of the proposed rule. One group of commenters recommended that the rule be broadened to apply to all non-audit services, rather than only tax services. Other commenters expressed concern that the rule appeared to impose restrictions on audit committee pre-approval in excess of the SEC's requirements and, for that reason, recommended that the Board narrow or eliminate the rule. The Board has determined not to change the scope of the rule in response to these comments. While auditors and audit committees may find the procedures in Rule 3524 to be useful for purposes of considering non-audit services generally, the Board adopts these rules only after having engaged in a substantial effort to obtain facts and views of interested persons on appropriate procedures for considering proposed tax services. Before considering broadening the rule, the Board would seek additional information, based, among other things, on experience with this rule, inspections of registered firms, and additional public input. On the other hand, notwithstanding the concerns of some commenters that Rule 3524 requires more than the parallel SEC rule, the Board has determined not to narrow or eliminate the rule. The Board continues to believe that the rule is an appropriate complement to the SEC's preapproval rule. Rule 3524 supports the procedure under the SEC rule, by requiring the auditor—who is in the best position to describe a proposed engagement—to gather the information required to be presented to the audit committee by the SEC rule. Indeed, it is the SEC rule and staff interpretations of what information audit committees need that have informed the Board's development of the rule.

The Board has made certain modifications to the proposed rule, however. As proposed, the rule would have required auditors to provide audit committees copies of all engagement letters for proposed tax services. While some commenters supported this proposal as a way to ensure that audit committees received adequate information on which to base their judgments, other commenters expressed concern that the rule could result in audit committees being provided voluminous stacks of engagement letters—some in foreign languages—that would obscure rather than elucidate the nature of the tax services proposed. On the basis of this information, and because the underlying purpose of the proposed requirement was to establish a manageable collection of information on which audit committees could make their determinations to pre-approve tax services, the Board has determined to eliminate the proposed rule's requirement to supply the audit committee a copy of each tax service engagement letter. Instead, the rule requires auditors to describe for audit committees, in writing, the scope

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[77] Taub Memo, *supra* note 71, at 3; *see also* FAQs, *supra* note 76, Audit Committee Pre-approval, Question 5 (issued August 13, 2003). The SEC staff FAQ answer states that ("[p]re-approval policies must be designed to ensure that the audit committee knows precisely what services it is being asked to pre-approve so that it can make a well-reasoned assessment of the impact of the service on the auditor's independence. For example, if the audit committee is presented with a schedule or cover sheet describing services to be pre-approved, that schedule or cover sheet must be accompanied by detailed back-up documentation regarding the specific services to be provided").

[78] *See* Rule 3524(a)(1). Audit committees may ask auditors for other materials not identified in the rule, to assist them in their determinations whether to preapprove proposed tax services. Rule 3524 should not be understood to limit the information or materials that an audit committee may request, or that a registered firm may decide to provide, in connection with the pre-approval of tax services.

of the proposed service, the proposed fee structure for the service, and the potential effect of the service on the auditor's independence. The Board believes requiring such a description of a proposed service better meets the Board's goal to improve the quality of information auditors provide audit committees about proposed tax services.

The rule also requires the auditor to describe for the audit committee any amendment to the engagement letter or any other agreement relating to the service (whether oral, written, or otherwise) between the firm and the audit client.[79] While the Board does not expect or encourage auditors to enter into side agreements relating to tax services, the Board understands that, in the past, some accounting firms have entered into such agreements.[80] To the extent firms do so, they must disclose those agreements to the audit committee.

In addition, to the extent that a firm receives fees or other consideration from a third party in connection with promoting, marketing, or recommending a tax transaction, Rule 3524 requires the firm to disclose those fees or other consideration to the audit committee. Specifically, Rule 3524(a)(2) requires that the firm disclose to the audit committee "any compensation arrangement or other agreement, such as a referral agreement, a referral fee or fee-sharing arrangement, between the registered public accounting firm (or an affiliate of the firm) and any person (other than the audit client) with respect to the promoting, marketing or recommending of a transaction covered by the service." This provision is adapted from the IRS's rules of practice, which require tax advisors to disclose such arrangements to taxpayer clients.[81]

Rule 3524(b) also requires registered public accounting firms to discuss with audit committees of their issuer audit clients the potential effects of any proposed tax services on the firm's independence. Even if a non-audit service does not per se impair an auditor's independence, the Commission's independence rules nevertheless deem an auditor not to be independent if—

> the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement.[82]

Rule 3524(b) is intended to provide audit committees a robust foundation of information upon which to determine whether to pre-approve proposed tax services. Some commenters have asked for guidance as to the scope of the discussions intended by the rule. The Board intends that the scope of such discussions remain flexible, to address the matters that are pertinent in the judgment of the audit committee, as informed by Commission requirements. While the Act's

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[79] *Id*. One commenter expressed concern that Rule 3524(a)'s requirement to describe an "other agreement" could be understood to require the auditor to submit to the audit committee documentation concerning "essentially every communication with the audit client." The Board believes this comment is misplaced. Rule 3524 does not require that the auditor describe all communications with the audit client, but rather all agreements with the audit client that relate to the proposed service.

[80] *See, e.g.*, *In re PricewaterhouseCoopers LLP, & PricewaterhouseCoopers Securities LLC*, *supra* note 43 ("through side letters or oral understandings, the parties created contingent fee arrangements"). In addition, some commenters have expressed concern that Rule 3524 requires disclosure to the audit committee of fee arrangements that are prohibited by Rule 3521 (or by professional association membership requirements, such as certain referral agreements and fees). Those commenters have asked the Board to clarify that Rule 3524 does not operate to permit such fee structures that are otherwise prohibited by the Board's rules or to endorse fee structures that are prohibited or discouraged by professional ethics rules. It is the case that Rule 3524 does not permit or otherwise endorse such fees.

[81] See 31 C.F.R. §10.35(e)(1) (2005), *available at* http://www.irs.gov/pub/irspdf/ pcir230.pdf.

[82] 17 C.F.R. § 210.2-01(b).

legislative history makes clear that the Act "does not require the audit committee to make a particular finding in order to pre-approve an activity,"[83] the Commission's staff expects a robust review of proposed non-audit services—

> The audit committee must take its role seriously and perform diligent analyses and reviews that allow the committee to conclude that reasonable investors would view the auditor as capable of exercising objective and impartial judgment on all matters brought to the auditor's attention.[84]

To be clear, the rule does not prescribe any test for audit committees or require audit committees to make legal assessments as to whether proposed services are prohibited or permissible. Nor is the rule intended to limit an audit committee's discretion to establish its own more stringent pre-approval procedures. Rather, the rule directs registered firms to present detailed information and analysis to audit committees for audit committees' consideration, in their own judgment, of the best interests of the issuer and its shareholders.

In addition, through the discussion required by Rule 3524(b), the Board expects registered firms to convey to the audit committee information sufficient to distinguish between tax services that could have a detrimental effect on the firm's independence and those that would be unlikely to have a detrimental effect. Some commenters expressed concern that an example of such a distinction that the Board provided in the proposing release could be understood to suggest that audit committees should not permit an auditor to provide any tax services unless the company had an internal tax department and/or a tax director who could make sound management decision in the best interest of the company. The Board did not intend to suggest that particular functional departments or managers must exist at a company before its auditor may provide it tax services. Rather, the inquiry the auditor should engage in when proposing to provide tax services to an audit client is whether, in the particular case, the company has the capacity to make its own decisions regarding the proposed tax matter, such that the auditor would not be in the position of performing management functions or making management decisions for the company.[85] The resolution of this inquiry will vary depending on the nature of the tax matter at issue and the sophistication of the company, among other things.

Rule 3524, both as proposed and as adopted, is intentionally silent as to when a registered public accounting firm should provide the required information about a proposed tax service to an audit committee. This is because, under the SEC's 2003 independence rules, audit committees themselves may have policies that establish a procedure and schedule for audit committee review of non-audit services, including tax services.[86] Some commenters expressed concern that the rule might favor one approval method (*ad hoc*) over another (approval pursuant to policies and procedures). This is not the case. Similar to the SEC's 2003 independence rules, Rule 3524 does not dictate, or even express a preference as to, whether the documentation and discussions required under Rule 3524 should take place pursuant to an audit committee's policies and procedures on pre-approval or on an ad hoc basis. Many issuers have adopted

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[83] S. REP. No. 107-205, at 19 (2002).

[84] Taub Memo, *supra* note 71, at 7-8; *see also* FAQs, *supra* note 76, Audit Committee Pre-approval, Question 5 (issued August 13, 2003).

[85] *See* PCAOB Rule 3600T (adopting *AICPA Code of Professional Conduct*, paragraph .05 of ET sec. 101, "Independence", Interpretation No. 101-3, "Performance of Other Services," as of April 16, 2003) ("care should be taken not to perform management functions or make management decisions for attest clients the responsibility for which remains with the client's board of directors and management.") (Interpretation No. 101-3 was later amended by the AICPA in December 2003).

[86] 17 C.F.R. § 210.2-01(c)(7)(i)(B).

policies that provide for pre-approval in annual audit committee meetings. The Board understands that such an annual planning process can include as robust a presentation to the audit committee as a case-by-case pre-approval process, and Rule 3524 is designed to be flexible enough to accommodate either system and to encourage auditors and audit committees to develop systems tailored to the needs and attributes of the issuer.

The timing and method by which auditors describe for, and discuss with, audit committees proposed tax services will necessarily vary depending on different audit committees procedures. For those audit committees that hold an annual meeting to consider proposed non-audit services for the upcoming year, often by reviewing a proposed annual budget for non-audit services, it would be appropriate for auditors to provide their disclosures pursuant to Rule 3524(a), and hold their discussions pursuant to Rule 3524(b), about proposed tax services that are known at the time of the meeting in connection with or at that meeting. In addition, some audit committees' policies delegate authority to pre-approve non-audit services to one committee member and require reporting of any services approved by delegated authority at the next scheduled audit committee meeting, on a quarterly basis, or otherwise, in order for the audit committee to review an updated forecast or other summary of non-audit services. In such cases, it would be appropriate for auditors to provide the member holding delegated authority to approve a tax service a description of the service that complies with Rule 3524(a). Also, although the auditor may discuss the service with the member holding delegated authority when the member is considering the service, in order to comply with Rule 3524(b), the auditor ought to discuss the service with the audit committee as a whole when the audit committee considers the updated forecast or other summary.

Finally, Rule 3524(c) requires a registered public accounting firm to document the substance of its discussion with the audit committee under subparagraph (b). The few commenters who addressed this provision supported it.[87]

III. Effective and Transition Dates

The Board intends that the rules become effective at varying times.

In light of pre-existing legal and regulatory requirements, Rules 3502 and 3520 do not, in any practical sense, create new criteria for appropriate conduct. Accordingly, no transition period is called for, and therefore the Board intends that Rules 3502 and 3520, as well as the definitions in Rule 3501, become effective 10 days after the date that the SEC approves the rules.

Rule 3521 is based on the SEC's existing contingent fee rule, although it differs from that rule in certain respects. Accordingly, the Board will not apply Rule 3521 to contingent fee arrangements that were paid in their entirety, converted to fixed fee arrangements, or otherwise unwound before the later of December 31, 2005, or 10 days after the date that the SEC approves the rules. Of course, as noted above, the Commission's Rule 2-01 on auditor independence treats an auditor as not independent if it enters into a contingent fee arrangement with an audit client today.[88]

Rules 3522, 3523, and 3524 establish new criteria for appropriate conduct by registered public accounting firms and their associated persons. The Board believes it is appropriate to allow a reasonable period of time for such firms to

[87] One commenting auditor suggested that the Board consider requiring specific forms or occasions for auditor documentation of audit committee discussion. After considering this suggestion, the Board has determined that such forms or required timing of discussions could unnecessarily limit the scope of the discussions that, in the judgment of the auditor and audit committee, are appropriate.

[88] 17 C.F.R. § 210.2-01(c)(5).

prepare internal policies and procedures, and train their employees to ensure compliance with these new requirements. In addition, the Board understands that engagements covered by these rules may be in progress and that firms will need to terminate or complete these engagements in a professional manner. Accordingly, the Board believes it is appropriate to allow transition periods for these rules.

The Board understands that Rule 3523 will, in practical effect, lead to some registered firms terminating recurring engagements to provide tax services and may require certain members of public companies' senior management to find other tax preparers. Accordingly, the Board has determined that it will not apply Rule 3523 to tax services being provided pursuant to an engagement in process at the time the SEC approves the rules, provided that such services are completed on or before the later of June 30, 2006 or 10 days after the date that the SEC approves the rules. As discussed above, the Board will treat engagements as "in process" if an engagement letter has been executed and work of substance has commenced; the Board will not treat engagements as "in process" during negotiations on the scope and fee for a service.

Although the Board does not expect them to require the same transition as Rule 3523, Rules 3522 and 3524 also impose new legal requirements. Accordingly, the Board has determined that it will not apply Rule 3522 to tax services that were completed by a registered public accounting firm no later than the later of December 31, 2005, or 10 days after the date that the SEC approves the rules. Rule 3524 will not apply to any tax service pre-approved before the later of December 31, 2005, or 10 days after the date that the SEC approves the rules, or, in the case of an issuer that pre-approves non-audit services by policies and procedures, the rule will not apply to any tax service provided by March 31, 2006.

On the 26th day of July, in the year 2005, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/
J. Gordon Seymour
Acting Secretary
December 14, 2004

APPENDIX—

Rules

Appendix

Rules

SECTION 3: PROFESSIONAL STANDARDS

Part 5 — Ethics

Rule 3501. Definitions of Terms Employed in Section 3, Part 5 of the Rules.

When used in Section 3, Part 5 of the Rules, unless the context otherwise requires:

(a)(i) Affiliate of the Accounting Firm

The term "affiliate of the accounting firm" (or "affiliate of the registered public accounting firm" or "affiliate of the firm") includes the accounting firm's parents; subsidiaries; pension, retirement, investment or similar plans; and any associated entities of the firm, as that term is used in Rule 2-01 of the Commission's Regulation SX, 17 C.F.R. § 210.2-01(f)(2).

(a)(ii) Affiliate of the Audit Client

The term "affiliate of the audit client" means—

(1) An entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client's parents and subsidiaries;

(2) An entity over which the audit client has significant influence, unless the entity is not material to the audit client;

(3) An entity that has significant influence over the audit client, unless the audit client is not material to the entity; and

(4) Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex.

(a)(iii) Audit and Professional Engagement Period

The term "audit and professional engagement period" includes both—

(1) The period covered by any financial statements being audited or reviewed (the "audit period"); and

(2) The period of the engagement to audit or review the audit client's financial statements or to prepare a report filed with the Commission (the "professional engagement period")—

(A) The professional engagement period begins when the registered public accounting firm either signs an initial engagement letter (or other agreement to review or audit a client's financial statements) or begins audit, review, or attest procedures, whichever is earlier; and

(B) The professional engagement period ends when the audit client or the registered public accounting firm notifies the Commission that the client is no longer that firm's audit client.

(3) For audits of the financial statements of foreign private issuers, the "audit and professional engagement period" does not include periods ended prior to the first day of the last fiscal year before the

foreign private issuer first filed, or was required to file, a registration statement or report with the Commission, provided there has been full compliance with home country independence standards in all prior periods covered by any registration statement or report filed with the Commission.

(a)(iv) Audit Client

The term "audit client" means the entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client.

(c)(i) Contingent Fee

The term "contingent fee" means—

(1) Except as stated in paragraph (2) below, any fee established for the sale of a product or the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service.

(2) Solely for the purposes of this definition, a fee is not a "contingent fee" if the amount is fixed by courts or other public authorities and not dependent on a finding or result.

(f)(i) Financial Reporting Oversight Role

The term "financial reporting oversight role" means a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

(i)(i) Investment Company Complex

(1) The term "investment company complex" includes—

(i) An investment company and its investment adviser or sponsor;

(ii) Any entity controlled by or controlling an investment adviser or sponsor in paragraph (i) of this definition, or any entity under common control with an investment adviser or sponsor in paragraph (i) of this definition if the entity—

(A) Is an investment adviser or sponsor; or

(B) Is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment adviser, or sponsor; and

(iii) Any investment company or entity that would be an investment company but for the exclusions provided by section 3(c) of the Investment Company Act of 1940 (15 U.S.C. § 80a-3(c)) that has an investment adviser or sponsor included in this definition by either paragraph (i) or (ii) of this definition.

(2) An investment adviser, for purposes of this definition, does not include a sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser.

(3) A sponsor, for purposes of this definition, is an entity that establishes a unit investment trust.

Rule 3502. Responsibility Not to Cause Violations.

A person associated with a registered public accounting firm shall not cause that registered public accounting firm to violate the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards, due to an act or omission the person knew or should have known would contribute to such violation.

Subpart 1—Independence

Rule 3520. Auditor Independence.

A registered public accounting firm must be independent of its audit client throughout the audit and professional engagement period.

Note: Under Rule 3520, a registered public accounting firm's independence obligation with respect to an audit client that is an issuer encompasses not only an obligation to satisfy the independence criteria set out in the rules and standards of the PCAOB, but also an obligation to satisfy all other independence criteria applicable to the engagement, including the independence criteria set out in the rules and regulations of the Commission under the federal securities laws.

Rule 3521. Contingent Fees.

A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any service or product to the audit client for a contingent fee or a commission, or receives from the audit client, directly or indirectly, a contingent fee or commission.

Rule 3522. Tax Transactions.

A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any non-audit service to the audit client related to planning, or opining on the tax treatment of, a transaction—

(a) **Listed Transactions**—that is a listed transaction within the meaning of 26 C.F.R. §6011.1-4(b)(2);

(b) **Confidential Transactions**—that is a confidential transaction within the meaning of 26 C.F.R. §6011.1-4(b)(3), or that would be a confidential transaction within the meaning of 26 C.F.R. §6011.1-4(b)(3) if the fee for the transaction were equal to or more than the minimum fee described in 26 C.F.R. §6011.1-4(b)(3); or

(c) Aggressive Tax Positions—that was initially recommended by the registered public accounting firm or another tax advisor and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws.

Rule 3523. Tax Services for Senior Officers of Audit Client.

A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any tax service to an officer in a financial reporting oversight role at the audit client.

Rule 3524. Audit Committee Pre-approval of Certain Tax Services.

In connection with seeking audit committee pre-approval to perform for an audit client any permissible tax service, a registered public accounting firm shall—

(a) provide to the audit committee of the audit client—

(i) the engagement letter relating to the service, which shall include descriptions of the scope of the service and the fee structure, any amendment to the engagement letter, or any other agreement (whether oral, written, or otherwise) between the firm and the audit client, relating to the service; and

(ii) any compensation arrangement or other agreement, such as a referral agreement, a referral fee or fee-sharing arrangement, between the registered public accounting firm (or an affiliate of the firm) and any person (other than the audit client) with respect to the promoting, marketing, or recommending of a transaction covered by the service;

(b) discuss with the audit committee the potential effects of the services on the independence of the firm; and

(c) document the substance of its discussion with the audit committee.

PCAOB Release No. 2005-015

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

PCAOB Release No. 2005-015
July 26, 2005
PCAOB Rulemaking
Docket Matter No. 018

Approved by the Securities and Exchange Commission on February 6, 2006, and is effective as of February 6, 2006.

Summary:

After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") has adopted Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*. The Board will submit this standard to the Securities and Exchange Commission ("Commission" or "SEC") for approval pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 (the "Act"). This standard will not take effect unless approved by the Commission.

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I. Background

Congress enacted Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") to provide investors with increased transparency about public companies' internal control over financial reporting. Since then, approximately 12.7 percent of public companies that are accelerated filers[1] have reported that their internal control over financial reporting is not effective because one or more material weaknesses in internal control over financial reporting existed as of the company's fiscal year-end.[2] When a company reports a material weakness, investors may be left uncertain about the reliability of the company's financial reporting. They may also want information about the company's plans for remediating the material weakness and its timeframe for doing so, and to be notified when the material weakness has been eliminated. Thus, a disclosure that internal

[1] An "accelerated filer," as defined in Rule 12b-2 under the Securities Exchange Act of 1934, 17 C.F.R. § 240.12b-2, is generally a U.S. company that, among other things, has equity market capitalization over $75 million and has filed at least one annual report with the Commission.

[2] See Paul J. Martinek, Adjustments, Restatements Are Predictors Of Weaknesses, Compliance Week (June 14, 2005).

control over financial reporting is not effective is often only the beginning of a company's communications with investors concerning the material weakness (or weaknesses) that caused the problem.[3]

Both companies and report users have recognized the importance of a mechanism for companies to effectively communicate with the markets when a previously reported material weakness in internal control over financial reporting no longer exists.[4] In many cases, companies will find the mechanisms for company disclosures already provided by the federal securities laws sufficient. For example, a public company is required to disclose quarterly any changes in internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.[5] Investors will, therefore, learn of material improvements, such as the correction of a material weakness, on at least a quarterly basis through these required disclosures.[6] Under the Board's Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Connection with an Audit of Financial Statements*, the company's auditor is responsible for evaluating these quarterly disclosures.[7] Finally, investors will also learn about the status of previously reported material weaknesses (as well as internal control over financial reporting overall), accompanied by auditor assurance, when the company files its next annual report. Investors and issuers, however, have called for the ability to obtain auditor assurance as of an interim date that a previously reported material weakness no longer exists. At the November 18, 2004, SAG Meeting, several members of the group with experience as investors and issuers encouraged the Board to develop a standard that would describe this type of engagement for the auditor. In particular, several issuer members of the SAG emphasized that companies that have reported a material weakness will want to have options available to assure the markets that the material weakness has been remediated.[8]

II. Public Comment on the Board's Proposal

On March 31, 2005, the Board issued for public comment a proposed auditing standard titled "Reporting on the Elimination of a Material Weakness." In response, the Board received 30 comment letters from a variety of interested parties, including auditors, investors, issuers, and others. The comment letters

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[3] Some companies with material weaknesses have already begun this process by including detailed descriptions of their remediation plans in their annual filings or by providing additional disclosures in subsequent filings on the steps they are continuing to take to remediate the weaknesses. See June 2005 Internal Control Report: All About Remediation, Compliance Week (July 6, 2005).

[4] The Board's Standing Advisory Group ("SAG") discussed possible auditor involvement with the elimination of a material weakness at its November 18, 2004 public meeting ("SAG Meeting"). An archived webcast of the SAG Meeting and a related briefing paper on this topic, "Reporting on the Correction of a Material Weakness," are available on the PCAOB's Web site at www.pcaobus.org.

[5] See Item 308(c) of Regulation S-K, 17 C.F.R. §229.308(c).

[6] Of course, through this same mechanism, investors also could learn if internal control over financial reporting deteriorates materially during the year.

[7] See Paragraphs 202–206 of Auditing Standard No. 2, as well as PCAOB Staff Question and Answer No. 55 regarding the extent of these responsibilities. The Staff Questions and Answers are available on the Board's Web site under Standards at www.pcaobus.org.

[8] See Nick S. Cyprus, Vice President, Controller and Chief Accounting Officer, The Interpublic Group of Companies, Remarks at SAG Meeting (Nov. 18, 2004) ("I guarantee there will be demand [for such a standard]"); Sam Cotterell, Vice President and Controller, Boise Cascade LLC, Remarks at SAG Meeting (Nov. 18, 2004) ("if I have a material weakness disclosed, I want a mechanism to let the market know that that has been fixed. I want to do that as quickly as possible.").

included detailed discussion of a wide range of topics. Many commenters expressed strong support for the standard.[9]

Other comments included:

- suggestions regarding the wording of the auditor's opinion and the title of the proposed standard;
- discussion of several technical issues, such as the standard's focus on control objectives, consideration of materiality, and the potential need for the auditor to perform substantive procedures;
- suggestions regarding the auditor's responsibility when new material weaknesses are identified during this engagement, and when all previously reported material weaknesses are not being reported upon by the auditor;
- concerns that, although an engagement under the standard would be completely voluntary, it could become compulsory, as a practical matter, if investors begin to insist on auditor attestation in all cases in which a material weakness is identified;
- a suggestion that the conforming amendment be modified to allow auditors to use AT 101 strictly for a company's internal use.

The Board carefully considered all of the comment letters that it received. A detailed analysis of comments and the Board's responses are contained in the Background and Basis for Conclusions, in Appendix B of the standard.

III. Summary of Changes to the Proposed Standard

The Board adopted Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, after making several changes to the proposed standard in response to comments. The more significant changes include—

- revising the form of the auditor's opinion to clarify that the purpose of the engagement is to determine whether the material weakness "exists" or "no longer exists" and making related changes to the title of the standard;
- conforming text in the conditions for engagement performance to the text of a parallel provision in PCAOB Auditing Standard No. 2, due to the close relationship between the two standards. Specifically, the Board clarified that under Auditing Standard No. 4, management's evidence includes documentation;
- adding guidance on the subjects of materiality, control objectives and substantive procedures;
- adding a responsibility for the auditor to inform the audit committee if the auditor identifies a new material weakness during an engagement performed under this standard;

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[9] See Letter from Laurie Fiori Hacking, Executive Director, Ohio Public Employees Retirement System, to J. Gordon Seymour, Acting Secretary, PCAOB (Apr. 15, 2005) ("The elimination of a material weakness, accompanied by an independent auditor's interim report attesting to management's assessment of its internal controls, will increase investor confidence in the reliability of a company's financial statements."); Letter from Gregory J. Jonas, Managing Director, Moody's Investors Service, to Office of the Secretary, PCAOB (May 5, 2005) ("the proposed standard strikes a useful balance by giving companies the option to provide users with information they value and with the assurance they find useful while not requiring a complete re-assessment").

- modifying the required elements of the auditor's report to clarify that a continuing auditor previously obtained an understanding of internal control over financial reporting and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the specified material weakness;
- including additional illustrative auditor's reports; and
- modifying the conforming amendment to the Board's interim attestation standards to allow auditors to continue to use AT 101 for engagements to report on whether a material weakness continues to exist if such a report is intended strictly for a company's internal use.

These changes have been reflected in the adopted standard, and are discussed further in the Background and Basis for Conclusions, included in Appendix B of the standard.

IV. Overview of the Engagement

This standard establishes a stand-alone engagement that is entirely voluntary, performed only at the company's request. This type of reporting is not required by the Act or the standards or rules of the PCAOB, and should not be viewed as compulsory. The Board anticipates that in deciding whether to engage their auditors to report on whether a particular material weakness continues to exist, companies will weigh the costs and benefits and do so only when it is cost-effective. Based on the investor and issuer comments at the SAG Meeting, the Board believes that, in some situations, companies will find that auditor assurance that a material weakness no longer exists leads to a higher level of investor confidence in a company's financial reporting, and that the costs of the engagement are therefore worth incurring. If a company believes, however, that these benefits would be outweighed in a particular case by the costs of obtaining them, the company may (and presumably would) determine not to engage its auditor to perform this work.

Although the Board designed this standard to be a cost-effective means of providing investors assurance that a material weakness no longer exists, the Board expects that this engagement will be best suited and most cost-effective for reporting on material weaknesses that are discrete problems with a limited effect on the company's internal control over financial reporting. Reporting on material weaknesses that have a pervasive effect on the company's internal control over financial reporting could require such a broad and extensive base of work that the Board anticipates that a company in this situation would choose to wait for the auditor's annual audit of internal control over financial reporting conducted under Auditing Standard No. 2 to obtain auditor assurance that a pervasive material weakness no longer exists.

The objective of an auditor's engagement under this standard is to express an opinion on whether a previously reported material weakness continues to exist. The standard, therefore, draws from many concepts applicable to the auditor's report on the effectiveness of internal control over financial reporting, as described in Auditing Standard No. 2, although in a more narrowly focused and limited manner. For this reason, most of the requirements in the standard will be familiar to auditors. In designing this standard, the Board provided flexibility wherever possible, to allow auditors to conduct the engagement in a manner suited to the material weakness in internal control over financial reporting at issue.

Similar to any other attestation service, an auditor's report under this standard is based on an evaluation of management's assertion that the material weakness no longer exists. This standard establishes several conditions that must be met for the auditor to perform this engagement. These conditions were patterned after management's responsibilities under the SEC's rules implementing Section 404 of the Act[10] and the corresponding conditions in Auditing Standard No. 2.[11] These conditions include management accepting responsibility for internal control over financial reporting, evaluating the effectiveness of the specified controls that address the material weakness, asserting that the specified controls are effective in addressing the material weakness, and supporting its assertion with sufficient evidence, including documentation.

The auditor's assurance resulting from this engagement is that the previously reported material weakness, in the auditor's opinion, no longer exists as of a specified date. Although the auditor's evaluation of the design and operating effectiveness of the identified controls generally follows the requirements of PCAOB Auditing Standard No. 2, this engagement is designed to be significantly narrower in scope because the auditor's testing is limited to the controls specifically identified by management as addressing the material weakness. Both management and the auditor use the company's stated control objective as the target for determining whether the specified controls sufficiently address the material weakness. (See Section VI for further discussion of the determination that a material weakness no longer exists.)

V. Auditor's Report

To communicate clearly the narrow focus of this engagement, the standard requires the auditor's report to describe the material weakness, identify all of the specified controls that management asserts address the material weakness, and identify the stated control objective achieved by these controls. The report also is required to include language to emphasize to readers that the auditor has not performed procedures sufficient to reach conclusions about the effectiveness of any other controls or provided an opinion regarding the effectiveness of internal control over financial reporting overall.[12] Report users should thus understand the limited scope of the auditor's opinion.

To render an opinion that a material weakness no longer exists, the auditor must have obtained evidence about the design and operation of the relevant controls, determined that the material weakness no longer exists, and determined that no scope limitations were placed on the auditor's work. Because of the narrow focus of this engagement, qualified opinions are not permitted. Limitations on the scope of the auditor's work preclude the auditor from rendering an opinion. The auditor's opinion as to whether a previously reported material weakness continues to exist may be expressed as "the material weakness exists" or "the material weakness no longer exists." Accordingly, the standard does not distinguish between an unqualified opinion and an adverse opinion but simply refers to the auditor's opinion.

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[10] See Item 308(a) of Regulation S-K, 17 C.F.R. §229.308(a).

[11] See Paragraph 20 of Auditing Standard No. 2.

[12] The SAG Meeting included a discussion about the importance of such a report clearly communicating to report users the scope of the engagement. Several SAG members emphasized the potential for report users to believe, mistakenly, that the auditor, as a result of this limited engagement, had rendered a current opinion regarding the effectiveness of internal control over financial reporting overall. Comments received on the proposed standard generally expressed overall support for the clarity of the proposed auditor's report in this regard.

Unlike an auditor's report on internal control over financial reporting, in which the assessment is required to be as of the date of the annual financial statements, an auditor's report on whether a material weakness continues to exist may be as of any date set by management. The "as of" date of management's assertion represents the day the company believes the material weakness no longer exists and that the company has adequately assessed the effectiveness of the specified controls that address the material weakness. In the event that the auditor begins testing and concludes that additional remediation is required to address the material weakness, the company has the opportunity to re-address its remediation efforts, reset the assertion date, and ask the auditor again to opine on whether the material weakness continues to exist.

If the auditor determines that a material weakness continues to exist and does not issue a report, the standard requires the auditor to communicate to the company's audit committee, in writing, his or her conclusion that the material weakness continues to exist. Similarly, the auditor also has a responsibility to communicate to the audit committee, in writing, any new material weaknesses that the auditor identifies during this engagement that the auditor has not already communicated in writing to the audit committee. The standard also addresses the circumstance in which the auditor reports on fewer than all of the previously reported material weaknesses. In this circumstance, the standard requires the auditor to include language in his or her report stating that his or her previously issued report on management's annual assessment of the company's internal control over financial reporting identified additional material weaknesses, that the auditor is not reporting on those other material weaknesses, and that the auditor, accordingly, is expressing no opinion on whether those material weaknesses exist after the company's year-end.[13]

VI. Determining That a Material Weakness No Longer Exists

The standard requires the auditor to obtain evidence sufficient to determine whether the design and operation of the controls identified by management achieve the *stated control objectives* and that the material weakness no longer exists. A control objective for internal control over financial reporting generally relates to a relevant financial statement assertion, such as whether certain recorded transactions are genuine, and provides a basis for evaluating the effect of a company's controls on that assertion.[14] A stated control objective in the context of this engagement is the specific control objective identified by management that, if achieved, would result in the material weakness no longer existing. For this reason, management and the auditor must be satisfied that, if the stated control objective were achieved, the material weakness would no longer exist.

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[13] Several investors, among others, suggested that, in the circumstance in which additional material weaknesses were previously reported but are not the subject of the auditor's report on whether a material weakness continues to exist, the auditor's report should draw attention to these other material weaknesses. In response to these comments, the standard states that when referring to his or her previously issued report, the auditor is required either to attach that report to his or her report on whether the material weakness continues to exist or to include information about where the previously issued report can be publicly obtained.

[14] See Paragraphs 68 through 70 of Auditing Standard No. 2 for additional information on relevant assertions.

When a material weakness has a pervasive effect on the company's internal control over financial reporting, identifying the control objectives that are not being met may be difficult because of the large number of control objectives affected. A material weakness related to an ineffective control environment is an example of this situation. If management and the auditor have difficulty in identifying *all* of the stated control objectives affected by a material weakness, the material weakness is probably not suitable for this type of narrow, interim reporting and should be tested, instead, during the auditor's annual audit of internal control over financial reporting conducted under Auditing Standard No. 2.

VII. Using the Work of Others

Auditing Standard No. 4 applies the same framework for using the work of others as the one described in Auditing Standard No. 2. Similar to Auditing Standard No. 2, the standard permits the auditor to use the work of others to alter the nature, timing, and extent of the auditor's performance of work related to this engagement. This framework requires the auditor to obtain the principal evidence supporting his or her opinion and to evaluate the nature of the controls being tested, together with the competence and objectivity of the persons performing the work.

Under both Auditing Standard No. 2 and this standard, the framework measures principal evidence in relation to the overall assurance provided by the auditor. Under Auditing Standard No. 2, the principal evidence supporting the auditor's opinion should be evaluated in relation to the auditor's opinion on internal control over financial reporting overall. Under this standard, the evaluation of whether the auditor has obtained the principal evidence supporting his or her opinion needs to be applied at the control objective level. It should be noted, however, that this does not require the auditor to obtain the principal evidence that each control specifically identified in management's assertion as related to the identified control objectives is effective.

There may be some circumstances in which the scope of the audit procedures to be performed in this type of engagement will be so limited that using the work of others will not provide any tangible benefit to the company or its auditor. The flexibility that the framework otherwise provides, however, is meant to encourage auditors to evaluate whether opportunities exist to use the work of others in this context.

VIII. Effective Date of the Standard

The standard will be effective as of the date of SEC approval.

* * *

On the 26th day of July, in the year 2005, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Acting Secretary
July 26, 2005

APPENDICES—

1. Auditing Standard No. 4—*Reporting on Whether a Previously Reported Material Weakness Continues to Exist*
2. Conforming Amendment to PCAOB Auditing and Related Professional Practice Standards Resulting from the Adoption of Auditing Standard No. 4—*Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

Appendix 1

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

Applicability of Standard

1. This standard establishes requirements and provides direction that apply when an auditor is engaged to report on whether a previously reported material weakness in internal control over financial reporting (hereinafter referred to as a material weakness) continues to exist as of a date specified by management.

> Note 1: In this context, *previously reported material weakness* means a material weakness that was described previously in an auditor's report issued pursuant to Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*.
>
> Note 2: The date specified by management as the date that the previously reported material weakness no longer exists must be a date after the date of management's most recent annual assessment.

2. An auditor may conduct an engagement to report on whether a previously reported material weakness continues to exist if (1) the auditor has audited the company's financial statements and internal control over financial reporting in accordance with Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, as of the date of the company's most recent annual assessment of internal control over financial reporting, or (2) the auditor has been engaged to perform an audit of the financial statements and internal control over financial reporting in accordance with Auditing Standard No. 2 in the current year and has a sufficient basis for performing this engagement. (See paragraph 26 of this standard for additional requirements that apply specifically to a successor auditor's application of this standard.)

> Note: References in this standard to the company's most recent annual assessment of internal control over financial reporting apply to the company's most recent assessment of internal control over financial reporting overall, either as of the company's year-end or as of a more recent interim date, as audited by the auditor in accordance with Auditing Standard No. 2.

3. The auditor may report on more than one previously reported material weakness as part of a single engagement.

4. The engagement described by this standard is voluntary. The standards of the PCAOB do not require an auditor to undertake an engagement to report on whether a previously reported material weakness continues to exist. The auditor may audit the company's internal control over financial reporting in accordance with Auditing Standard No. 2 without ever performing an engagement in accordance with this standard.

Auditor's Objective in an Engagement to Report on Whether a Previously Reported Material Weakness Continues to Exist

5. The auditor's objective in an engagement to report on whether a previously reported material weakness continues to exist is to obtain reasonable

assurance about whether the previously reported material weakness exists as of a date specified by management and to express an opinion thereon. The auditor's opinion relates to the existence of a specifically identified material weakness as of a specified date and does not relate to the effectiveness of the company's internal control over financial reporting overall.

6. To obtain reasonable assurance, the auditor should obtain and evaluate evidence about whether specified controls were designed and operated effectively as of the date specified by management and whether those controls satisfy the company's stated control objective.

Note: Obtaining and evaluating evidence about whether the specified controls are designed effectively without also obtaining evidence about whether those controls operated effectively would not result in the auditor obtaining reasonable assurance for the purpose of expressing an opinion on whether a material weakness continues to exist.

Conditions for Engagement Performance

7. The auditor may report on whether a previously reported material weakness continues to exist at a company only if all of the following conditions are met:

a. Management accepts responsibility for the effectiveness of internal control over financial reporting;

b. Management evaluates the effectiveness of the specific control(s) that it believes addresses the material weakness using the same control criteria that management used for its most recent annual assessment of internal control over financial reporting and management's stated control objective(s);

c. Management asserts that the specific control(s) identified is effective in achieving the stated control objective;

d. Management supports its assertion with sufficient evidence, including documentation; and

e. Management presents a written report that will accompany the auditor's report that contains all the elements described in paragraph 48 of this standard.

8. If all the conditions in paragraph 7 of this standard are not met, the auditor is not permitted to complete the engagement to report on whether a previously reported material weakness continues to exist.

Framework and Definitions for Evaluation

9. The terms *internal control over financial reporting*, *control deficiency*, *significant deficiency*, and *material weakness* have the same meanings as the definitions of those terms in paragraphs 7 through 10, respectively, of Auditing Standard No. 2.

10. Paragraph 13 of Auditing Standard No. 2 states that management is required to base its annual assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework (also known as *control criteria*) and describes the characteristics that make a framework suitable for this purpose. For purposes of an engagement to report on whether a previously reported material weakness continues to exist, both management and the auditor must use both (1) the same control criteria used for the company's most recent annual assessment of internal control over

financial reporting, and (2) the company's stated control objective(s) to evaluate whether a material weakness continues to exist.

> Note: The performance and reporting requirements in Auditing Standard No. 2 and in this standard are based on the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission's publication, *Internal Control—Integrated Framework*. Known as the COSO report, it provides a suitable and available framework for purposes of management's annual assessment of internal control over financial reporting. (More information about the COSO framework is included in paragraphs 14 and 15 of Auditing Standard No. 2, the COSO report, and AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*.)

11. A *control objective* provides a specific target against which to evaluate the effectiveness of controls. A control objective for internal control over financial reporting generally relates to a relevant financial statement assertion and states a criterion for evaluating whether the company's control procedures in a specific area provide reasonable assurance that a misstatement to or omission in that relevant assertion is prevented or detected by controls on a timely basis.[1]

12. Management establishes control objectives that are tailored to the individual company. The process of tailoring control objectives to the individual company allows the control criteria used for management's annual assessment to be applied to the facts and circumstances in a reasonable and appropriate manner. Although control objectives are used most frequently to evaluate the effectiveness of control activities, the other components of internal control over financial reporting (i.e., control environment, risk assessment, information and communication, and monitoring) also can be expressed in terms of control objectives.

13. In an audit of internal control over financial reporting, the auditor is required to identify the company's control objectives in each area and to identify the controls that satisfy each control objective to evaluate whether the company's internal control over financial reporting is designed effectively.[2]

14. Table 1 includes examples of control objectives and their related assertions:

Table 1—Examples of Control Objectives and Related Assertions

Control Objectives	Assertions
Recorded sales of product X initiated on the company's Web site are real	Existence or occurrence
Product X warranty losses that are probable and can be reasonably estimated are recorded as of the company's quarterly financial statement period-ends	Completeness

(continued)

[1] See paragraphs 68 to 70 of Auditing Standard No. 2 for additional information on relevant assertions.

[2] See paragraph 88 of Auditing Standard No. 2

Control Objectives	Assertions
Interest rate swaps are recorded at fair value	Valuation or allocation
The company has legal title to recorded product X inventory in the company's Dallas, TX warehouse	Rights and obligations
Pending litigation that is reasonably possible to result in a material loss is disclosed in the quarterly and annual financial statements	Presentation and disclosure

15. If a material weakness has previously been reported, a necessary control objective (or objectives) has not been achieved.

16. A *stated control objective* in the context of an engagement to report on whether a material weakness continues to exist is the specific control objective identified by management that, if achieved, would result in the material weakness no longer existing.

17. Because the stated control objective, for purposes of this engagement, provides management and the auditor with a specific target against which to evaluate whether the material weakness continues to exist, management and the auditor must be satisfied that, if the stated control objective were achieved, the material weakness would no longer exist.

Note: When a material weakness has a pervasive effect on the company's internal control over financial reporting, identifying the related control objectives that are not being achieved may be difficult because of the large number of control objectives affected. A material weakness related to an ineffective control environment would be an example of this circumstance. If management and the auditor have difficulty identifying *all* of the stated control objectives affected by a material weakness, the material weakness probably is not suitable for this engagement and should be addressed, instead, through the auditor's annual audit of internal control over financial reporting conducted under Auditing Standard No. 2.

Performing an Engagement to Report on Whether a Previously Reported Material Weakness Continues to Exist

18. In an engagement to report on whether a previously reported material weakness continues to exist, the auditor must obtain sufficient competent evidence about the design and operating effectiveness of specified controls that provide reasonable assurance that the company's stated control objective is achieved in the context of the control criteria (e.g., COSO).

Note 1: An individual material weakness may be associated with a single stated control objective or with more than one stated control objective, depending on the nature of the material weakness and the manner in which the company tailors its stated control objectives to its business.

Note 2: Depending on the nature of the company's business, its organization, its internal control over financial reporting, and the specific material weakness that is the subject of this engagement, the auditor may determine that he or she is not able to obtain a sufficient basis for reporting on whether a previously reported material weakness continues to exist without performing a complete audit of internal control over financial reporting in accordance with Auditing Standard No. 2.

Applying the Standards of the PCAOB

19. The auditor must adhere to the standards of the PCAOB in performing an engagement to report on whether a previously reported material weakness continues to exist. Adherence to the standards involves:

a. Planning the engagement,

b. Obtaining an understanding of internal control over financial reporting,

c. Testing and evaluating whether a material weakness continues to exist, including using the work of others, and

d. Forming an opinion on whether a previously reported material weakness continues to exist.

20. Even though some requirements of this standard are set forth in a manner that suggests a sequential process, auditing whether a previously reported material weakness continues to exist involves a process of gathering, updating, and analyzing information. Accordingly, the auditor may perform some of the procedures and evaluations described in this section of the standard concurrently.

21. The engagement to report on whether a previously reported material weakness continues to exist must be performed by a person or persons having adequate technical training and proficiency as an auditor. In all matters related to the assignment, an independence in mental attitude must be maintained. Due professional care must be exercised in the performance of the engagement and the preparation of the report. Paragraphs 30 through 36 of Auditing Standard No. 2 describe the application of these standards in the context of an internal control-related service.

22. This standard establishes the fieldwork and reporting standards applicable to an engagement to report on whether a previously reported material weakness continues to exist.

23. The concept of materiality, as discussed in paragraphs 22 and 23 of Auditing Standard No. 2, underlies the application of the general and fieldwork standards in an engagement to report on whether a previously reported material weakness continues to exist. Therefore, the auditor uses materiality at the financial-statement level, rather than at the individual account-balance level, in evaluating whether a material weakness exists. The auditor should assess materiality as of the date that management asserts that the previously reported material weakness no longer exists.

Planning the Engagement

24. The auditor should properly plan the engagement to report on whether a previously reported material weakness continues to exist and should properly supervise any assistants. When planning the engagement, the auditor should evaluate how the matters described in paragraph 39 of Auditing Standard No. 2 will affect the auditor's procedures.

Obtaining an Understanding of Internal Control over Financial Reporting

25. To perform this engagement, the auditor must have a sufficient knowledge of the company and its internal control over financial reporting. An auditor who has audited the company's internal control over financial reporting in accordance with Auditing Standard No. 2 as of the date of the company's most recent annual assessment of internal control over financial reporting would be expected to have obtained a sufficient knowledge of the company and its internal control over financial reporting to perform this engagement.

Note: The second sentence of the paragraph above contemplates that the auditor's previous engagement under Auditing Standard No. 2 resulted in rendering an opinion. If an auditor previously engaged to perform an audit of internal control over financial reporting in accordance with Auditing Standard No. 2 has not yet rendered an opinion on the effectiveness of the company's internal control over financial reporting as of the company's most recent year-end or more recently, then that auditor should follow the requirements for a successor auditor in paragraphs 26a-b and 27. Additionally, if an auditor has previously performed an audit of internal control over financial reporting at the company and is now a successor auditor (because another auditor has subsequently performed an audit of internal control over financial reporting at the company in intervening years), the auditor should follow the requirements in paragraphs 26 and 27 for a successor auditor.

26. When a successor auditor[3] performs an engagement to report on whether a previously reported material weakness continues to exist and he or she has not yet completed an audit of internal control over financial reporting at the company, he or she must perform procedures to obtain sufficient knowledge of the company's business and its internal control over financial reporting to achieve the objective of the engagement, as described in paragraph 5 of this standard. A successor auditor who has not yet completed an audit of internal control over financial reporting at the company must perform the following procedures as part of obtaining sufficient knowledge of the company's business and its internal control over financial reporting:

a. Comply with paragraphs 47 through 51 of Auditing Standard No. 2 regarding obtaining an understanding of internal control over financial reporting. The extent of understanding of internal control over financial reporting needed to satisfy these requirements in the context of an engagement to report on whether a previously reported material weakness continues to exist depends on the nature of the material weakness on which the auditor is reporting. The more pervasive the effects of the material weakness, the more extensive the understanding of internal control over financial reporting should be under these requirements. For example, if the material weakness affects company-level controls, a more extensive understanding of internal control over financial reporting will be necessary than if the effects of the material weakness are isolated at the transaction level.

b. Perform a walkthrough as described in paragraphs 79 through 82 of Auditing Standard No. 2 for all major classes of transactions that are directly affected by controls specifically identified by management as addressing the material weakness.

   Note: Some controls have only an indirect effect on a major class of transactions, such as certain controls in the control environment or risk assessment components of internal control over financial reporting. The auditor need not perform a walkthrough of major classes of transactions that are affected only indirectly by the controls specifically identified by management as addressing the material weakness.

c. In addition to the communication requirements described in AU sec. 315, *Communications Between Predecessor and Successor Auditors*, the successor auditor should make specific inquiries of the

[3] The term *successor auditor* has the same meaning as the definition of that term in paragraph .02 of AU sec. 315, *Communications Between Predecessor and Successor Auditors*.

predecessor auditor. These inquiries should address the basis for the predecessor auditor's determination that a material weakness existed in the company's internal control over financial reporting and the predecessor auditor's awareness of any information bearing on the company's ability to successfully address that material weakness.

27. A successor auditor may determine that he or she needs to perform procedures in addition to those specified in paragraph 26 of this standard to obtain a sufficient knowledge of the company's business and its internal control over financial reporting. Depending on the nature of the company's business, its organization, its internal control over financial reporting, and the specific material weakness that is the subject of this engagement, a successor auditor may determine that he or she is not able to obtain a sufficient basis for reporting on whether a previously reported material weakness continues to exist without performing a complete audit of internal control over financial reporting in accordance with Auditing Standard No. 2.

Testing and Evaluating Whether a Material Weakness Continues to Exist

28. The auditor must obtain an understanding of and evaluate management's evidence supporting its assertion that the specified controls related to the material weakness are designed and operated effectively, that these controls achieve the company's stated control objective(s) consistent with the control criteria, and that the identified material weakness no longer exists. If the auditor determines that management has not supported its assertion with sufficient evidence, the auditor cannot complete the engagement to report on whether a previously reported material weakness continues to exist, because one of the conditions for engagement completion described in paragraph 7 of this standard would not be met.

Note: Paragraphs 40 through 46 of Auditing Standard No. 2 apply to the auditor's evaluation of management's annual assessment of internal control over financial reporting and management's related documentation. The auditor may apply the relevant concepts described in that section to the evaluation of management's evidence supporting management's assertion that a previously reported material weakness no longer exists.

29. As a part of evaluating management's evidence supporting its assertion, the auditor should determine whether management has selected an appropriate date for its assertion. In making this determination, the auditor should take into consideration the following:

a. Management's assertion that a previously reported material weakness no longer exists may be made as of any specified date that permits management to obtain sufficient evidence supporting its assertion.

   Note: The auditor also should determine whether the specified date of management's assertion permits the auditor to obtain sufficient evidence supporting his or her opinion.

b. Depending on the nature of the material weakness, the stated control objective, and the specified controls, the specified date of management's assertion may need to be after the completion of one or more period-end financial reporting processes.

c. Controls that operate daily and on a continuous, or nearly continuous, basis generally permit the auditor to obtain sufficient

evidence as to their operating effectiveness as of almost any date management might choose to specify in its report.

d. Controls that operate over the company's period-end financial reporting process typically can be tested only in connection with a period-end.

30. The auditor should obtain evidence about the effectiveness of all controls specifically identified in management's assertion. The nature, timing, and extent of the testing that enables the auditor to obtain sufficient evidence supporting his or her opinion on whether a previously reported material weakness continues to exist will depend on both the nature of the controls specifically identified by management as meeting the company's stated control objectives and the date of management's assertion.

31. All controls that are necessary to achieve the stated control objective(s) should, therefore, be specifically identified and evaluated. The specified controls will necessarily include controls that have been modified or newly implemented and also may include existing controls that previously were deemed effective during management's most recent annual assessment of internal control over financial reporting. As part of testing and evaluating the design effectiveness of the specified controls, the auditor should determine whether the specified controls would meet the stated control objective(s) if they operated as designed. In making this evaluation, the auditor should apply paragraphs 88 through 91 of Auditing Standard No. 2.

32. Consistent with the direction in paragraph 92 of Auditing Standard No. 2, the auditor should evaluate the operating effectiveness of a specified control by determining whether the specified control operated as designed and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively. In determining the nature, timing, and extent of tests of controls, the auditor should apply paragraphs 93 through 102 and 105 through 107 of Auditing Standard No. 2.

33. The auditor should apply paragraph 98 of Auditing Standard No. 2 regarding an adequate period of time to determine the operating effectiveness of a control in the context of an engagement to report on whether a previously reported material weakness continues to exist. Paragraph 98 of Auditing Standard No. 2 states (in part):

> The auditor must perform tests of controls over a period of time that is adequate to determine whether, as of the date specified in management's report, the controls necessary for achieving the objectives of the control criteria are operating effectively. The period of time over which the auditor performs tests of controls varies with the nature of the controls being tested and with the frequency with which specific controls operate and specific policies are applied.

For example, a transaction-based daily reconciliation generally would permit the auditor to obtain sufficient evidence as to its operating effectiveness in a shorter period of time than a pervasive, company-level control, such as any of those described in paragraphs 52 and 53 of Auditing Standard No. 2. Additionally, the auditor typically will be able to obtain sufficient evidence as to the operating effectiveness of controls over the company's period-end financial reporting process only by testing those controls in connection with a period-end.

34. The auditor should determine whether, based on the nature of the material weakness, performing substantive procedures to support recorded financial statement amounts or disclosures affected by the specifically identified controls is necessary to obtain sufficient evidence regarding the operating effectiveness of those controls. For example, a material weakness in the company's controls over the calculation of its bad debt reserve ordinarily would require

that the auditor also perform substantive procedures to obtain sufficient evidence supporting an opinion about whether the material weakness continues to exist as of a specified date. In this circumstance, in addition to testing the design and operating effectiveness of the controls specifically identified as achieving the company's stated control objective that its bad debt reserve is reasonably estimated and recorded, the auditor ordinarily would need to perform substantive procedures to determine that, as of that same specified date, the company's bad debt reserve was fairly stated in relation to the company's financial statements taken as a whole.

35. When the specified controls, stated control objectives, and material weakness affect multiple locations or business units of the company, the auditor may apply the relevant concepts in paragraphs B1 through B13 of Appendix B of Auditing Standard No. 2 to determine the locations or business units at which to perform procedures.

Using the Work of Others

36. The auditor should evaluate whether to use the work performed by others in an engagement to report on whether a previously reported material weakness continues to exist. To determine the extent to which the auditor may use the work of others to alter the nature, timing, or extent of the work the auditor otherwise would have performed, the auditor should apply paragraphs 109 through 115 and 117 through 125 of Auditing Standard No. 2.

37. The auditor's opinion relates to whether a material weakness no longer exists at the company because the stated control objective(s) is met. Therefore, if the auditor has been engaged to report on more than one material weakness or on more than one stated control objective, the auditor must evaluate whether he or she has obtained the principal evidence that the control objectives related to each of the material weaknesses identified in management's assertion are achieved. The auditor may, however, use the work of others to alter the nature, timing, or extent of the work he or she otherwise would have performed. For these purposes, the work of others includes relevant work performed by internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provide information about the effectiveness of internal control over financial reporting.

38. Paragraph 122 of Auditing Standard No. 2 should be applied in the context of the engagement to report on whether a previously reported material weakness continues to exist. Paragraph 122 states, in part, "As the significance of the factors listed in paragraph 112 increases, the ability of the auditor to use the work of others decreases at the same time that the necessary level of competence and objectivity of those who perform the work increases." There may, therefore, be some circumstances in which the scope of the audit procedures to be performed in this engagement will be so limited that using the work of others will not provide any tangible benefit to the company or its auditor. Additionally, the auditor should perform any walkthroughs himself or herself because of the degree of judgment required in performing this work.

> Note: The requirement described in paragraph 26b of this standard for the auditor to perform a walkthrough applies only to an auditor who did not complete an audit of internal control over financial reporting as of the company's most recent annual assessment. An auditor who has rendered an opinion on the effectiveness of the company's internal control over financial reporting in accordance with Auditing Standard No. 2 as of the company's most recent annual assessment is not required to perform a walkthrough as part of this engagement.

39. The following example illustrates how to apply this section on using the work of others to this engagement.

In this example, the company's previously reported material weakness relates to the company's failure to perform bank reconciliations at its 50 subsidiaries. The specified controls identified by the company are the timely preparation of complete and accurate reconciliations between the company's recorded cash balances and the company's cash balances as reported by its financial institution.

Although certain controls over bank reconciliations are centralized, the performance of the bank reconciliations themselves is not centralized because they occur at each individual operating unit. Further, each operating unit has, on average, three separate cash accounts. The cash accounts affected are not material individually but are material in the aggregate. Most of the controls over the preparation of bank reconciliations involve a low degree of judgment in evaluating their operating effectiveness, can be subjected to objective testing, and have a low potential for management override.

If these conditions describe the specified controls over the preparation of bank reconciliations, the auditor could determine that, based on the nature of the controls as described above, he or she could use the work of others to a moderate extent, provided that the degree of competence and objectivity of the individuals performing the tests is high. The auditor might perform tests of controls that are centralized at the holding company level himself or herself; perform testing at a limited number of locations himself or herself; test the work of others performed at a limited number of other locations; review the results of the work of others at all other locations tested; and determine that, qualitatively and quantitatively, principal evidence had been obtained.

On the other hand, if the company's previously reported material weakness related to the company's failure to perform a reconciliation of its only cash account, few controls and few operations of those controls would underlie management's assertion that the material weakness no longer exists. In this circumstance, it is unlikely that the auditor would be able to use a significant amount of the work of others because of the limited scope of the total amount of work needed to test management's assertion and due to the requirement that the auditor obtain the principal evidence himself or herself.

Note: The examples provided in paragraph 126 of Auditing Standard No. 2 illustrate how to apply the requirements in Auditing Standard No. 2 regarding using the work of others in an audit of internal control over financial reporting. Because of the differences between the auditor obtaining the principal evidence supporting an opinion on the effectiveness of internal control over financial reporting overall and supporting an opinion on the much narrower subject of whether a specified material weakness in internal control over financial reporting continues to exist, the examples in Auditing Standard No. 2 may not illustrate the appropriate application of using the work of others in this narrower engagement. For instance, the examples in paragraph 126 of Auditing Standard No. 2 suggest that, for certain controls, the auditor could potentially use the work of others in its entirety. However, in most cases, the auditor could not solely use the work of others for a control specified in management's assertion regarding a material weakness no longer existing and, at the same time, obtain the principal evidence supporting his or her opinion. As another example, Auditing Standard No. 2 describes an example of appropriately alternating tests of controls. Alternating tests of controls is applicable only in the context of a recurring engagement, which is not the context for the auditor's reporting on whether a previously reported material weakness continues to exist.

Opinions Based, in Part, on the Work of Another Auditor

40. The auditor may apply the relevant concepts in AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, in an engagement to report on whether a previously reported material weakness continues to exist, with the following exception. If the auditor decides to serve as the principal auditor and to use the work and reports of another auditor as a basis, in part, for his or her opinion, the principal auditor must not divide responsibility for the engagement with the other auditor. Therefore, the principal auditor must not make reference to the other auditor in his or her report.

Forming an Opinion on Whether a Previously Reported Material Weakness Continues to Exist

41. When forming an opinion on whether a previously reported material weakness continues to exist, the auditor should evaluate all evidence obtained from all sources. This process should include an evaluation of the sufficiency of the evidence obtained by management and the results of the auditor's evaluation of the design and operating effectiveness of the specified controls.

42. Management may conclude that a previously reported material weakness no longer exists because it has been reduced to a significant deficiency. If management does not plan to correct the significant deficiency within a reasonable period of time, the auditor should evaluate whether the remaining significant deficiency could be indicative of a material weakness in internal control over financial reporting. Under paragraph 140 of Auditing Standard No. 2, a significant deficiency not corrected after some reasonable period of time is a strong indicator of a material weakness. Because the auditor is not required to provide an opinion under this voluntary engagement, the auditor could reasonably decline to provide an opinion under such circumstances.

43. The auditor may issue an opinion on whether a previously reported material weakness continues to exist only when there have been no restrictions on the scope of the auditor's work. Because of the scope of an engagement to report on whether a previously reported material weakness continues to exist, any limitations on the scope of the auditor's work require the auditor either to disclaim an opinion or to withdraw from the engagement. A qualified opinion is not permitted.

> Note: As described in paragraph 51 of this standard, the auditor's opinion on whether a previously reported material weakness continues to exist may be expressed as "the material weakness exists" or "the material weakness no longer exists." Therefore, the provisions of this standard do not distinguish between an unqualified opinion and an adverse opinion and, instead, refer simply to "an opinion" or "the auditor's opinion."

Requirement for Written Representations

44. In an engagement to report on whether a previously reported material weakness continues to exist, the auditor should obtain written representations from management:

a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;

b. Stating that management has evaluated the effectiveness of the specified controls using the specified control criteria and management's stated control objective(s);

c. Stating management's assertion that the specified controls are effective in achieving the stated control objective(s) as of a specified date;

d. Stating management's assertion that the identified material weakness no longer exists as of the same specified date;

e. Stating that management believes that its assertions are supported by sufficient evidence;

f. Describing any material fraud and any other fraud that, although not material, involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting and that has occurred or come to management's attention since the date of management's most recent annual assessment of internal control over financial reporting; and

g. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect the stated control objective(s) or indicate that the identified controls were not operating effectively as of, or subsequent to, the date specified in management's assertion.

45. The written representations should be signed by those members of management with overall responsibility for the company's internal control over financial reporting whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Such members of management ordinarily include the chief executive officer and chief financial officer or others with equivalent positions in the company.

46. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the engagement. As discussed further in paragraph 43 of this standard, if there is a limitation on the scope of an engagement to report on whether a previously reported material weakness continues to exist, the auditor must either disclaim an opinion or withdraw from the engagement. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations of management, including, if applicable, representations obtained in an audit of the company's financial statements.

Documentation Requirements

47. The documentation requirements in Auditing Standard No. 3, *Audit Documentation*, are modified in the following respect as they apply to this engagement. Paragraph 14 of Auditing Standard No. 3 defines the *report release date* as the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements. As described in paragraph 29 of this standard, management's assertion that a material weakness no longer exists may be made as of a date other than a period-end financial reporting date. Therefore, the auditor's release of a report on whether a previously reported material weakness continues to exist may not necessarily be associated with the issuance of financial statements of the company. Accordingly, in an engagement to report on whether a previously reported material weakness continues to exist, the report release date for purposes of applying Auditing Standard No. 3 is the date the auditor grants permission to use the auditor's report on whether a previously reported material weakness continues to exist.

Reporting on Whether a Previously Reported Material Weakness Continues to Exist

Management's Report

48. As a condition for the auditor's performance of this voluntary engagement, management is required to present a written report that will accompany the auditor's report, as described in paragraph 7e of this standard. To satisfy this condition for the auditor's performance of this engagement, management's report should include:

a. A statement of management's responsibility for establishing and maintaining effective internal control over financial reporting for the company;

b. A statement identifying the control criteria used by management to conduct the required annual assessment of the effectiveness of the company's internal control over financial reporting;

c. An identification of the material weakness that was identified as part of management's annual assessment;

Note: This report element should be modified in the case in which management's annual assessment did not identify the material weakness, but, rather, only the auditor's report on management's annual assessment identified the material weakness.

d. An identification of the control objective(s) addressed by the specified controls and a statement that the specified controls achieve the stated control objective(s) as of a specified date; and

e. A statement that the identified material weakness no longer exists as of the same specified date because the specified controls address the material weakness.

Auditor's Evaluation of Management's Report

49. With respect to management's report, the auditor should evaluate the following matters:

a. Whether management has properly stated its responsibility for establishing and maintaining effective internal control over financial reporting;

b. Whether the control criteria used by management to conduct the evaluation is suitable;

c. Whether the material weakness, stated control objectives, and specified controls have been properly described; and

d. Whether management's assertions, as of the date specified in management's report, are free of material misstatement.

50. If, based on the results of this evaluation, the auditor determines that management's report does not include the elements described in paragraph 48 of this standard, the conditions for engagement performance have not been met.

Auditor's Report

51. The auditor's report on whether a previously reported material weakness continues to exist must include the following elements:

a. A title that includes the word *independent*;

b. A statement that the auditor has previously audited and reported on management's annual assessment of internal control over financial reporting as of a specified date based on the control criteria, as well as a statement that the auditor's report identified a material weakness;

Note: This report element should be modified in cases in which a successor auditor's performance of this engagement is occurring before he or she has opined on the effectiveness of internal control over financial reporting overall in accordance with Auditing Standard No. 2. In this circumstance, the auditor's report should refer to the predecessor auditor's report on management's annual assessment and the predecessor auditor's identification of the material weakness.

c. A description of the material weakness;

d. An identification of management's assertion that the identified material weakness in internal control over financial reporting no longer exists;

e. An identification of the management report that includes management's assertion, such as identifying the title of the report (if the report is titled);

f. A statement that management is responsible for its assertion;

g. An identification of the specific controls that management asserts address the material weakness;

Note: As discussed further in paragraph 31, all controls that are necessary to achieve the stated control objective should be identified.

h. An identification of the company's stated control objective that is achieved by these controls;

i. A statement that the auditor's responsibility is to express an opinion on whether the material weakness continues to exist as of the date of management's assertion based on his or her auditing procedures;

j. A statement that the engagement was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);

k. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the engagement to obtain reasonable assurance about whether a previously reported material weakness continues to exist at the company;

l. A statement that the engagement includes examining evidence supporting management's assertion and performing such other procedures the auditor considered necessary in the circumstances and that the auditor obtained an understanding of internal control over financial reporting as part of his or her previous audit of management's annual assessment of internal control over financial reporting and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the material weakness;

Note: This report element should be modified in cases in which a successor auditor's performance of this engagement is occurring

before he or she has opined on the effectiveness of internal control over financial reporting overall in accordance with Auditing Standard No. 2. In this circumstance, the auditor's report should include a statement that the engagement includes obtaining an understanding of internal control over financial reporting, examining evidence supporting management's assertion, and performing such other procedures as the auditor considered necessary in the circumstances.

m. A statement that the auditor believes the auditing procedures provide a reasonable basis for his or her opinion;

n. The auditor's opinion on whether the identified material weakness exists (or no longer exists) as of the date of management's assertion;

o. A paragraph that includes the following statements:

- That the auditor was not engaged to and did not conduct an audit of internal control over financial reporting as of the date of management's assertion, the objective of which would be the expression of an opinion on the effectiveness of internal control over financial reporting, and that the auditor does not express such an opinion, and
- That the auditor has not applied auditing procedures sufficient to reach conclusions about the effectiveness of any controls of the company as of any date after the date of management's annual assessment of the company's internal control over financial reporting, other than the controls specifically identified in the auditor's report, and that the auditor does not express an opinion that any other controls operated effectively after the date of management's annual assessment of the company's internal control over financial reporting.

  Note: This report element statement should be modified in the case in which a successor auditor's performance of this engagement is occurring before he or she has opined on the effectiveness of internal control over financial reporting overall in accordance with Auditing Standard No. 2 to read as follows: That the auditor has not applied auditing procedures sufficient to reach conclusions about the effectiveness of any controls of the company other than the controls specifically identified in the auditor's report and that the auditor does not express an opinion that any other controls operated effectively.

p. A paragraph stating that, because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of the effectiveness of specific controls or internal control over financial reporting overall to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate;

q. The manual or printed signature of the auditor's firm;

r. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

s. The date of the auditor's report.

52. Example A-1 in Appendix A is an illustrative auditor's report for an opinion that a material weakness no longer exists, expressed by an auditor who has previously reported on the company's internal control over financial reporting in accordance with Auditing Standard No. 2 as of the company's most recent year-end (herein after referred to as a continuing auditor). Example A-2 in Appendix A is an illustrative auditor's report for an opinion that a material weakness no longer exists expressed by a successor auditor.

53. As stated in paragraph 3 of this standard, the auditor may report on more than one previously reported material weakness as part of the same engagement. In this circumstance, the auditor should modify the report elements described in paragraph 51 of this standard accordingly.

54. *Report modifications.* The auditor should modify the standard report if any of the following conditions exist.

a. Other material weaknesses that were reported previously by the company as part of the company's annual assessment of internal control are not addressed by the auditor's opinion. (See paragraph 56 of this standard.)

b. A significant subsequent event has occurred since the date being reported on. (See paragraphs 57 and 58 of this standard.)

c. Management's report on whether a material weakness continues to exist includes additional information. (See paragraphs 59 through 60 of this standard.)

55. As described further in paragraph 43 of this standard, the form of the auditor's report resulting from an engagement to report on whether a previously reported material weakness continues to exist may be an opinion on whether a material weakness continues to exist, or it may be in the form of a disclaimer of opinion. A qualified opinion is not permitted. Any limitations on the scope of the auditor's work preclude the expression of an opinion. In addition to these reporting alternatives, an auditor may elect not to report on whether a material weakness continues to exist and, instead, withdraw from the engagement.

56. *Other material weaknesses reported previously by the company as part of the company's annual assessment of internal control are not addressed by the auditor's opinion.* In the circumstance in which the company previously has reported more than one material weakness, the auditor may be engaged to report on whether any or all of the material weaknesses continue to exist. If the auditor reports on fewer than all of the previously reported material weaknesses, the auditor should include the following or similar language in the paragraph that states that the auditor was not engaged to perform an audit of internal control over financial reporting. When referring to his or her previously issued report on management's annual assessment, the auditor should either attach that report or include information about where it can be publicly obtained.

> Our report on management's annual assessment of XYZ Company's internal control over financial reporting, dated [*date of report*], [attached or *identify location of where the report is publicly available*] identified additional material weaknesses other than the one identified in this report. We are not reporting on those other material weaknesses and, accordingly, express no opinion regarding whether those material weaknesses continue to exist after [*date of management's annual assessment, e.g., December 31, 200X*]. [*Revise this wording*

and references or attachments appropriately for use in a successor auditor's report.]

Example A-3 in Appendix A is an illustrative report issued by a continuing auditor reporting on only one material weakness when additional material weaknesses previously were reported.

57. *Subsequent events.* A change in internal control over financial reporting or other factors that might significantly affect the effectiveness of the identified controls or the achievement of the company's stated control objective might occur subsequent to the date of management's assertion but before the date of the auditor's report. Therefore, the auditor should inquire of management whether there was any such change or factors. As described in paragraph 44 of this standard, the auditor should obtain written representations from management regarding such matters. Additionally, to obtain information about whether such a change has occurred that might affect the effectiveness of the identified controls or the achievement of the company's stated control objective and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following:

- Internal audit reports (or similar functions, such as loan review in a financial institution) relevant to the stated control objective or identified controls issued during the subsequent period;
- Independent auditor reports (if other than the auditor's) of significant deficiencies or material weaknesses relevant to the stated control objective or identified controls;
- Regulatory agency reports on the company's internal control over financial reporting relevant to the stated control objective or identified controls; and
- Information about the effectiveness of the company's internal control over financial reporting relevant to the stated control objective or identified controls obtained as a result of other engagements.

58. If the auditor obtains knowledge about subsequent events that he or she believes adversely affect the effectiveness of the identified controls or the achievement of the stated control objective as of the date specified in management's assertion, the auditor should follow the requirements in paragraph 61 regarding special considerations when a material weakness continues to exist. If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the identified controls or the achievement of the stated control objective, the auditor should disclaim an opinion.

59. *Management's report includes additional information.* If management's report includes information in addition to the matters described in paragraph 48 of this standard, the auditor should disclaim an opinion on the additional information. For example, the auditor should use the following or similar language as the last paragraph of the report to disclaim an opinion on management's plans to implement new controls:

> We do not express an opinion or any other form of assurance on management's statement referring to its plans to implement new controls by the end of the year.

60. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If, after discussing the matter with management, the auditor

concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information.

Note: If management makes the types of disclosures described in paragraph 59 outside its report on whether a previously reported material weakness continues to exist and includes them elsewhere within a document that contains management's and the auditor's reports on whether a previously reported material weakness continues to exist, the auditor would not need to disclaim an opinion, as described in paragraph 59. However, in that situation, the auditor's responsibilities are the same as those described in this paragraph if the auditor believes that the additional information contains a material misstatement of fact.

Special Considerations When a Previously Reported Material Weakness Continues to Exist

61. If the auditor determines that the previously reported material weakness continues to exist and the auditor reports on the results of the engagement, he or she must express an opinion that the material weakness exists as of the date specified by management.

62. As described in paragraph 55, the auditor is not required to issue a report as a result of this engagement. If the auditor does not issue a report in this circumstance, he or she must communicate, in writing, his or her conclusion that the material weakness continues to exist to the audit committee. Similarly, if the auditor identifies a material weakness during this engagement that has not been previously communicated to the audit committee in writing, the auditor must communicate that material weakness, in writing, to the audit committee.

63. Additionally, whenever the auditor concludes that a previously reported material weakness continues to exist, the auditor must consider that conclusion as part of his or her evaluation of management's quarterly disclosures about internal control over financial reporting, as required by paragraphs 202 through 206 of Auditing Standard No. 2.

64. For example, if the auditor were engaged to report on whether two separate material weaknesses continue to exist and concluded that one no longer exists and one continues to exist, the auditor's report could comprise either of the following: (1) a report that contained two opinions, one on the material weakness that the auditor concluded no longer exists and one opinion on the material weakness that the auditor concluded continues to exist, or (2) a report that contained only a single opinion on the material weakness that the auditor concluded no longer exists if the company modifies its assertion to address only the material weakness that the auditor concluded no longer exists. In the second circumstance, the auditor must communicate, in writing, his or her conclusion that a material weakness continues to exist to the audit committee and also should apply paragraph 56 of this standard regarding other material weaknesses reported previously that are not addressed by the auditor's opinion. Additionally, the auditor must consider that conclusion as part of his or her evaluation of management's quarterly disclosures about internal control over financial reporting, as required by paragraphs 202 through 206 of Auditing Standard No. 2.

Effective Date

65. This standard is effective February 6, 2006.

Appendix A

Illustrative Reports on Whether a Previously Reported Material Weakness Continues to Exist

Paragraphs 51 through 60 of this standard provide direction on the auditor's report on whether a previously reported material weakness continues to exist. The following examples illustrate the application of those paragraphs.

Example A-1—*Illustrative Auditor's Report for a Continuing Auditor Expressing an Opinion That a Previously Reported Material Weakness No Longer Exists*

Example A-2—*Illustrative Auditor's Report for a Successor Auditor Expressing an Opinion That a Previously Reported Material Weakness No Longer Exists*

Example A-3—*Illustrative Auditor's Report for a Continuing Auditor Expressing an Opinion on Only One Previously Reported Material Weakness When Additional Material Weaknesses Previously Were Reported*

Example A-1

Illustrative Auditor's Report for a Continuing Auditor Expressing an Opinion That a Previously Reported Material Weakness No Longer Exists

Report of Independent Registered Public Accounting Firm

We have previously audited and reported on management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Our report, dated [*date of report*], identified the following material weakness in the Company's internal control over financial reporting:

[*Describe material weakness*]

We have audited management's assertion, included in the accompanying [title of management's report], that the material weakness in internal control over financial reporting identified above no longer exists as of [*date of management's assertion*] because the following control(s) addresses the material weakness:

[*Describe control(s)*]

Management has asserted that the control(s) identified above achieves the following stated control objective, which is consistent with the criteria established in [*identify control criteria used for management's annual assessment of internal control over financial reporting*]: [*state control objective addressed*]. Management also has asserted that it has tested the control(s) identified above and concluded that the control(s) was designed and operated effectively as of [*date of management's assertion*]. XYZ Company's management is responsible for its assertion. Our responsibility is to express an opinion on whether the identified material weakness continues to exist as of [*date of management's assertion*] based on our auditing procedures.

Our engagement was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the engagement to obtain reasonable assurance about whether a previously reported material weakness continues to exist at the company. Our engagement included examining evidence supporting management's assertion and performing such other procedures as we considered necessary in the circumstances. We obtained an understanding of the company's internal control over financial reporting as part of our previous audit of management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the material weakness described above. We believe that our auditing procedures provide a reasonable basis for our opinion.

In our opinion, the material weakness described above no longer exists as of [*date of management's assertion*].

We were not engaged to and did not conduct an audit of internal control over financial reporting as of [*date of management's assertion*], the objective of which would be the expression of an opinion on the effectiveness of internal control over financial reporting. Accordingly, we do not express such an opinion. This means that we have not applied auditing procedures sufficient to reach conclusions about the effectiveness of any controls of the company as of any date after

December 31, 200X, other than the control(s) specifically identified in this report. Accordingly, we do not express an opinion that any other controls operated effectively after December 31, 200X.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness of specific controls or internal control over financial reporting overall to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-2

Illustrative Auditor's Report for a Successor Auditor Expressing an Opinion That a Previously Reported Material Weakness No Longer Exists

Report of Independent Registered Public Accounting Firm

We were engaged to report on whether a previously reported material weakness continues to exist at XYZ Company as of [*date of management's assertion*] and to audit management's next annual assessment of XYZ Company's internal control over financial reporting. Another auditor previously audited and reported on management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. The other auditor's report, dated [*date of report*], identified the following material weakness in the Company's internal control over financial reporting:

[*Describe material weakness*]

We have audited management's assertion, included in the accompanying [title of management's report], that the material weakness in internal control over financial reporting identified above no longer exists as of [*date of management's assertion*] because the following control(s) addresses the material weakness:

[*Describe control(s)*]

Management has asserted that the control(s) identified above achieves the following stated control objective, which is consistent with the criteria established in [*identify control criteria used for management's annual assessment of internal control over financial reporting*]: [*state control objective addressed*]. Management also has asserted that it has tested the control(s) identified above and concluded that the control(s) was designed and operated effectively as of [*date of management's assertion*]. XYZ Company's management is responsible for its assertion. Our responsibility is to express an opinion on whether the identified material weakness continues to exist as of [*date of management's assertion*] based on our auditing procedures.

Our engagement was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the engagement to obtain reasonable assurance about whether a previously reported material weakness continues to exist at the company. Our engagement included obtaining an understanding of internal control over financial reporting, examining evidence supporting management's assertion, and performing such other procedures as we considered necessary in the circumstances. We believe that our auditing procedures provide a reasonable basis for our opinion.

In our opinion, the material weakness described above no longer exists as of [*date of management's assertion*].

We were not engaged to and did not conduct an audit of internal control over financial reporting as of [*date of management's assertion*], the objective of which would be the expression of an opinion on the effectiveness of internal control over financial reporting. Accordingly, we do not express such an opinion. This means that we have not applied auditing procedures sufficient to reach conclusions about the effectiveness of any controls of the company other than the control(s) specifically identified in this report. Accordingly, we do not express an opinion that any other controls operated effectively.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness of specific controls or internal control over financial reporting overall to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-3

Illustrative Auditor's Report for a Continuing Auditor Expressing an Opinion on Only One Previously Reported Material Weakness When Additional Material Weaknesses Previously Were Reported

Report of Independent Registered Public Accounting Firm

We have previously audited and reported on management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).*"]. Our report, dated [*date of report*], identified the following material weakness in the Company's internal control over financial reporting:

[*Describe material weakness*]

We have audited management's assertion, included in the accompanying [title of management's report], that the material weakness in internal control over financial reporting identified above no longer exists as of [*date of management's assertion*] because the following control(s) addresses the material weakness:

[*Describe control(s)*]

Management has asserted that the control(s) identified above achieves the following stated control objective, which is consistent with the criteria established in [*identify control criteria used for management's annual assessment of internal control over financial reporting*]: [*state control objective addressed*]. Management also has asserted that it has tested the control(s) identified above and concluded that the control(s) was designed and operated effectively as of [*date of management's assertion*]. XYZ Company's management is responsible for its assertion. Our responsibility is to express an opinion on whether the identified material weakness continues to exist as of [*date of management's assertion*] based on our auditing procedures.

Our engagement was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the engagement to obtain reasonable assurance about whether a previously reported material weakness continues to exist at the company. Our engagement included examining evidence supporting management's assertion and performing such other procedures as we considered necessary in the circumstances. We obtained an understanding of the company's internal control over financial reporting as part of our previous audit of management's annual assessment of XYZ Company's internal control over financial reporting as of December 31, 200X and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the material weakness described above. We believe that our auditing procedures provide a reasonable basis for our opinion.

In our opinion, the material weakness described above no longer exists as of [*date of management's assertion*].

We were not engaged to and did not conduct an audit of internal control over financial reporting as of [*date of management's assertion*], the objective of which would be the expression of an opinion on the effectiveness of internal control over financial reporting. Accordingly, we do not express such an opinion. This means that we have not applied auditing procedures sufficient to reach conclusions about the effectiveness of any controls of the company as of any date after December 31, 200X, other than the control(s) specifically identified in this

report. Accordingly, we do not express an opinion that any other controls operated effectively after December 31, 200X. Our report on management's annual assessment of XYZ Company's internal control over financial reporting, dated [*date of report*], [attached or *identify location of where the report is publicly available*] identified additional material weaknesses other than the one identified in this report. We are not reporting on those other material weaknesses and, accordingly, express no opinion regarding whether those material weaknesses continue to exist after [*date of management's annual assessment, e.g., December 31, 200X*].

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness of specific controls or internal control over financial reporting overall to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

[*Signature*]

[*City and State or Country*]

[*Date*]

Appendix B

Background and Basis for Conclusions

Introduction

B1. This appendix summarizes factors that the Public Company Accounting Oversight Board (the "Board") deemed significant in reaching the conclusions in the standard. This appendix includes reasons for accepting certain views and not accepting others.

Background

B2. Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") requires the management of public companies each year to file an assessment of the effectiveness of their companies' internal control over financial reporting. The company's independent auditor must attest to, and report on, management's assessment. Under the Securities and Exchange Commission's (the "SEC" or "Commission") implementing rules, company management may not conclude that internal control over financial reporting is effective if one or more material weaknesses exists.

B3. When a company reports a material weakness, investors may be left uncertain about the reliability of the company's financial reporting. Both companies and report users have recognized the importance of a mechanism for alerting investors that a previously disclosed material weakness no longer exists.[1] The federal securities laws provide part of that mechanism. Those laws require the company to disclose to investors any changes in internal control over financial reporting that occurred during the company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.[2] Therefore, investors will learn of material improvements, such as the remediation of a material weakness, on a timely basis through quarterly disclosures.[3]

B4. When a company determines that a material weakness has been remediated, it may determine that disclosure is sufficient. Some investors and companies, however, have called for the ability to bolster confidence in management's assertions about those internal control improvements with the added assurance of the company's independent auditor.[4]

B5. The Board reviewed its existing auditing and attestation standards to determine whether adequate standards governing such an engagement already existed. The Board's interim attestation standards provide requirements for general attest engagements; however, the Board determined that these standards lack sufficient specificity for this purpose.[5] The Board, therefore, proposed

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[1] The Board's Standing Advisory Group ("SAG") discussed possible auditor involvement with the elimination of a material weakness at its November 18, 2004, public meeting. The webcast of the November 18, 2004 SAG discussion and the related briefing paper on this topic, "Reporting on the Correction of a Material Weakness," are available on the Board's Web site at www.pcaobus.org.

[2] See Item 308(c) of Regulation S-K, 17 C.F.R. §229.308(c).

[3] In addition, even if internal control over financial reporting is effective as of the end of a company's fiscal year, investors also could potentially learn if it deteriorates materially during the year through these quarterly disclosures.

[4] The Standing Advisory Group's November 18, 2004 discussion included this type of encouragement.

[5] See AT sec. 101, "Attest Engagement" of the Board's interim standards. Effective April 16, 2003, the PCAOB adopted, on an initial, transitional basis, five temporary interim standards rules

(continued)

an auditing standard that would be tailored narrowly to an engagement to report on whether a previously reported material weakness continues to exist.

B6. The Board received 30 comment letters on its proposal, primarily from auditor and investor groups as well as from two issuers. Those comments led to changes in the standard, intended to make the requirements of the standard clearer and more operational. This appendix summarizes significant views expressed in those comment letters and the Board's responses.

Voluntary Nature of Engagement

B7. The proposed standard explicitly stated that the engagement described by this standard is voluntary and that the standards of the PCAOB did not require an auditor to undertake this engagement when a material weakness was previously reported. In addition, the Board stressed the voluntary nature of this engagement at the public meeting proposing this standard.

B8. The value and importance of the Board's standards providing the option of this type of auditor reporting on a material weakness was confirmed unanimously in the comment letters from investors and investor-related parties. Auditors were also supportive of the standard overall and its voluntary nature. Both of the issuers who commented indicated that they would be concerned if issuers become compelled to obtain such opinions. One of these commenters stressed that the disclosure requirements of management, coupled with enhanced criminal penalties, should provide investors with information regarding the continued existence or correction of a material weakness.

B9. The Board continues to believe that providing for this type of auditor reporting in its standards will serve the public interest. At the same time, the Board reaffirms that reporting on whether a material weakness continues to exist is a voluntary engagement and is not required by the standards of the PCAOB.

Form of the Auditor's Opinion

B10. The proposed standard called for the auditor to express a single opinion directly on the subject matter (i.e., the material weakness itself), rather than on management's assertion, as follows:

> In our opinion, XYZ Company has eliminated the material weakness described above as of [*date of management's assertion*] because the stated control objective is met as of [*date of management's assertion*].

B11. Primarily auditors commented on the form of the opinion in the proposed standard and their comments reflected a wide spectrum of ideas. Some commenters expressed support for the auditor's report, including the form of the opinion as proposed. Other comments included a suggestion for two opinions, consistent with Auditing Standard No. 2—one on the subject matter (the elimination of the material weakness) and one on management's assertion. Other

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(footnote continued)

(PCAOB Rules 3200T, 3300T, 3400T, 3500T, and 3600T) that refer to pre-existing professional standards of auditing, attestation, quality control, ethics, and independence (the "interim standards"). These rules were approved by the SEC on April 25, 2003. See SEC Release No. 33-8222. On December 17, 2003, the Board approved technical amendments to the interim standards rules indicating that, "when the Board adopts a new auditing and related professional practice standard that addresses a subject matter that also is addressed in the interim standards, the affected portion of the interim standards will be superseded or effectively amended. Accordingly, the Board approved adding the phrase 'to the extent not superseded or amended by the Board' to each of the interim standards rules." *Technical Amendments to Interim Standards Rules*, PCAOB Release No. 2003-026 (Dec. 17, 2003); Exchange Act Release No. 49624 (Apr. 28, 2004) (SEC Approval). The interim standards are available on the Board's Web site at www.pcaobus.org.

commenters suggested that just one opinion was sufficient, though these commenters were split regarding whether the one opinion should be on management's assertion or on the subject matter. Other commenters suggested that an opinion stating that the material weakness had been eliminated, without the phrase "because the stated control objective is met" would be a better alternative, while others asked the Board to consider an opinion stating that the identified controls were effective because the stated control objective was met, without stating that the material weakness had been eliminated.

B12. A number of commenters expressed concern with the phrasing "the material weakness has been eliminated," including the use of that phrase in the auditor's opinion and in the title of the proposed standard. These commenters believed that terminology such as "elimination" or "eliminated" might be too definite a term that might mislead report users into believing that there were no remaining deficiencies in the internal control over financial reporting in the area related to the specified material weakness, even though control deficiencies of a lesser severity than a material weakness might persist.

B13. After considering these suggestions, the Board decided to retain a single opinion on the subject matter and to revise the opinion wording. The Board continues to believe that a single opinion expressed directly on the subject matter is the simplest and clearest form of communication related to this engagement. Further, the Board believes that an auditor's opinion directly on the subject matter (i.e., the material weakness itself) will best achieve the overarching objective of this engagement—to clearly communicate as of an interim date auditor assurance about whether a previously reported material weakness continues to exist.

B14. The Board agreed with commenters that use of the term "elimination" might increase the risk that a report user would misunderstand the assurance provided by an auditor's opinion on a previously reported material weakness. As a result, the Board changed the form of the opinion to "In our opinion, the material weakness described above no longer exists as of [date of management's assertion]" and the title of the standard to "Reporting on Whether a Previously Reported Material Weakness Continues to Exist." The text of the standard was modified throughout to delete references to "eliminated" or "elimination" and to reflect wording consistent with the revised opinion and title.

As-of Date of Report

B15. The proposed standard provided for significant flexibility by allowing the engagement to be undertaken at any time during the year, limited only by implications associated with the nature of the material weakness. In other words, the proposed standard did not require the engagement to be performed in conjunction with an audit or review of financial statements. Instead, the proposed standard required the auditor to determine whether management had selected an appropriate date for its assertion and specified several matters for the auditor to consider in making this determination.

B16. A number of auditors suggested that the engagement described by the proposed standard should be performed only as of quarterly financial reporting dates instead of as of any date during the year. These commenters believed that such a requirement would allow the auditor to integrate this work with the auditor's interim review procedures under AU sec. 722, *Interim Financial Information*, and provide a link between the auditor's report on the material weakness and management's quarterly disclosures of material changes in internal control. Commenters noted that many of the material weaknesses that have been disclosed to date are related to the period-end financial reporting process and that the auditor would therefore need to test controls in connection

with a period-end to determine whether the material weakness continues to exist. Several commenters linked their suggestion that this engagement be performed only as of a quarterly financial reporting date to the view that the standard's direction on performing substantive procedures as part of this engagement should be bolstered (see separate discussion on performance of substantive procedures beginning at paragraph B51). One commenter pointed out, however, that if this engagement could be conducted only in connection with a quarterly financial reporting date, special guidance for applying the standard to foreign filers would be necessary because foreign filers are not required to report quarterly in the same manner as domestic filers.

B17. The Board believes that the flexibility provided in the proposed standard regarding the timing of the engagement is an important and appropriate feature of the standard. Although the Board agrees with commenters' observations that many of the material weaknesses disclosed during the past year were related to the period-end financial reporting process, the Board determined that the existing provisions of the proposed standard address this circumstance. In determining whether management has selected an appropriate date for its assessment, the standard requires the auditor to consider that controls that operate over the company's period-end financial reporting process typically can be tested only in connection with a period-end.

B18. Moreover, some material weaknesses—such as those that involve transaction-based controls that operate daily—are well suited for a management assertion and an auditor opinion that the material weakness no longer exists as of almost any date. Restricting an auditor's reporting on whether a material weakness continues to exist to only quarterly financial reporting dates could impose unnecessary delay on a company seeking auditor assurance that this type of material weakness no longer exists. For example, assume that a calendar year-end company had previously disclosed a material weakness that was the type that would lend itself well to reporting that it no longer existed as of any date. Further, management could not yet assert that the material weakness no longer existed as of March 31, but believed that it could make the assertion as of a date in April. If the standard restricted auditor reporting to a quarterly financial reporting date, the auditor would have to wait until June 30 to be able to attest to whether the material weakness continued to exist (and, presumably, would not be able to issue his or her report until July, at the earliest). While management could, in this example, provide timely disclosure to investors that the material weakness no longer existed, the Board concluded that structuring the provisions of the standard to potentially result in this kind of delay in auditor assurance would not serve the public interest.

B19. In light of these considerations, the Board decided to retain the provisions of the proposed standard that would permit the auditor to report on whether a previously reported material weakness continues to exist as of any date.

B20. At least one auditor asked for clarification about whether a report issued pursuant to Auditing Standard No. 2 that identified a material weakness could be issued at the same time as a report pursuant to this standard indicating that the material weakness no longer exists as of a later date. The degree of flexibility regarding the timing of this engagement would permit the company (depending on the company's ability to assert that a material weakness no longer exists and the auditor's ability to timely audit that assertion) to simultaneously distribute its annual reports and the management assertion and auditor report described in this standard. Consistent with this flexible approach, nothing in this standard or Auditing Standard No. 2 would preclude the auditor from issuing a single, combined report on the results of an audit of internal control

over financial reporting pursuant to Auditing Standard No. 2 and the results of an engagement performed pursuant to this standard.

Applicability of the Standard to Material Weaknesses Not Previously Reported

B21. The proposed standard was structured to allow an auditor to report only on a previously reported material weakness. The proposed standard defined a previously reported material weakness as a material weakness that was previously described by an auditor's report issued pursuant to Auditing Standard No. 2. A material weakness initially identified *after* the company's annual assessment date could not, therefore, be the subject of an auditor's report under the proposed standard.

B22. Virtually all of the investors who submitted comment letters suggested that the standard should allow for auditor reporting on material weaknesses identified subsequent to the company's most recent annual assessment of internal control over financial reporting. Although some of these commenters expressed concern about the level of work that might be required of the auditor to thoroughly understand a material weakness not previously reported upon by an auditor, they did not believe that the standard should prohibit such reporting. One commenter stated that if a successor auditor could gain an understanding of a company's internal control sufficient to report on a material weakness that was identified and reported on by a predecessor auditor, an auditor should be able to gain the understanding necessary to report on a material weakness identified by management as of an interim date.

B23. The majority of the auditors who commented indicated strong opposition to allowing auditors to report in this engagement on material weaknesses not previously reported. These commenters suggested that the initial identification of a material weakness requires a level of understanding of the company's controls and the specific facts and circumstances surrounding the material weakness that can result only from a complete evaluation of the effectiveness of internal control over financial reporting. Additionally, at least one commenter expressed concern that the identification of a material weakness subsequent to the annual assessment is a strong indicator of a material change within the company's internal control over financial reporting. This commenter believed that in such a circumstance the auditor would not have sufficient knowledge of the current state of internal control over financial reporting to be able to consider the interaction and potential implications of the change on other controls. This commenter also believed that this situation would prevent the auditor, in most cases, from being able to determine whether the newly identified material weakness no longer exists.

B24. The Board decided to retain the approach described by the proposed standard. The Board believes that the issue of a newly identified material weakness being an indicator of a material change within a company's internal control over financial reporting is a valid concern. Although the change in internal control over financial reporting giving rise to any new material weakness may be confined specifically to the area in which the material weakness originally was identified, the change also could be more far-reaching. In such circumstances, the auditor may not be able to determine the effect of the change without performing a full audit of internal control over financial reporting.

B25. The Board also notes that there is an important distinction between material weaknesses previously identified in an auditor's report issued pursuant to Auditing Standard No. 2 and other newly identified material weaknesses. The primary purpose of the narrow engagement described by this standard is to establish a timely and reasonable mechanism that a company can use to remove

any perceived "stain" upon its financial reporting due to an outstanding adverse audit opinion on internal control over financial reporting that identified a material weakness. In the case of a new material weakness that is identified and addressed by management as of an interim date, an adverse auditor opinion previously attesting to the material weakness would not exist and, therefore, the new material weakness would not be the subject of the same type of market focus.

B26. There is also a fundamental difference between the auditor reporting on a material weakness not previously reported and a successor auditor reporting on a material weakness that *was* reported in a predecessor auditor's opinion on internal control over financial reporting. The fundamental difference is the concept of material change described above. The successor auditor must obtain a sufficient understanding of the company's internal control over financial reporting to report on the existence of a material weakness that was previously reported. This successor auditor, however, has the benefit of knowing that the material weakness was identified in the context of an audit of the internal control over financial reporting as a whole and that the predecessor auditor should have adequately described the nature of the material weakness (particularly its pervasiveness and the extent of its effect on the company's financial reporting). In contrast, in situations in which a material change has taken place and a new material weakness has arisen after the previous annual assessment of internal control over financial reporting, neither the predecessor nor the successor auditor has obtained this level of understanding as it relates to the newly identified material weakness.

B27. These considerations, taken together, resulted in the Board's decision to retain the provisions of the proposed standard that limit this engagement only to material weaknesses that have been previously described in an auditor's report issued pursuant to Auditing Standard No. 2. The Board also made changes to the standard, as suggested by one commenter, to make these provisions clearer. These changes included changing the title of the standard to "Reporting on Whether a Previously Reported Material Weakness Continues to Exist" as well as conforming changes to the text of the standard to refer explicitly to a *previously reported* material weakness as the subject matter of this engagement.

Focus on Control Objectives

B28. The proposed standard focused on stated control objectives to determine whether a material weakness continues to exist and posited that if a material weakness has been disclosed previously, a necessary control objective at the company has not been achieved. Because the term "stated control objective" was not precisely defined elsewhere in the Board's auditing standards, the proposed standard provided a definition as well as examples of stated control objectives.

B29. A *stated control objective* in the context of this engagement is the specific control objective identified by management that, if achieved, would result in the material weakness no longer existing. The stated control objective would provide management and the auditor with a specific target against which to evaluate whether the material weakness continues to exist. For this reason, the proposed standard required that management and the auditor be satisfied that if the stated control objective were achieved the material weakness would no longer exist.

B30. Comments on the proposed standard's focus on control objectives came primarily from auditors. Many auditors, either explicitly or implicitly, supported the focus on control objectives. One auditor suggested that, given the importance of control objectives, the proposed standard should explicitly state that documentation of control objectives is required.

B31 Several auditors, however, expressed concerns about the proposed standard's focus on control objectives. A couple of these commenters suggested that the proposed standard's emphasis on control objectives might inappropriately establish a framework for evaluating the effectiveness of internal control over financial reporting that differs from, or otherwise adversely affects the proper application of, the Committee of Sponsoring Organizations of the Treadway Commission's publication *Internal Control—Integrated Framework* ("COSO").

B32. Most concerned commenters expressed apprehension that report users might be misled by an auditor's opinion that a material weakness had been eliminated because the control objectives had been met. They believed that this type of opinion might lead report users to mistakenly believe that if the control objectives were met, there were no remaining deficiencies in the internal control over financial reporting in the area related to the material weakness—when, in fact, a significant deficiency or deficiency could continue to exist.

B33. Another commenter noted that the examples in the proposed standard illustrated only control objectives for the control activities component of internal control over financial reporting—not for the other components (control environment, risk assessment, monitoring, information and communication). This commenter suggested that examples of control objectives in the other components would be helpful. Another commenter suggested that, given the importance of the control objective concept, if the Board's standards were to specifically address the concept, such a definition and discussion should reside in Auditing Standard No. 2. One concerned auditor concluded that, given the importance of control objectives, more guidance was needed, including clarification that if more than one control is necessary to achieve a stated control objective, all such controls must be identified and tested as part of this engagement.

B34. In response to comments, the Board decided to retain the definition of, and focus on, control objectives and provide additional guidance. The Board views the auditor's use of the concept of control objectives as analogous to the use of the concept of relevant assertions. The concept of relevant assertions was already familiar to experienced auditors and was specifically defined for the first time in Auditing Standard No. 2 because of that standard's focus on testing controls over all relevant assertions related to all significant accounts. Similarly, the concept of control objectives is familiar to most experienced auditors and is already used to describe the auditor's responsibilities under Auditing Standard No. 2).[6] A definition of control objectives (and stated control objectives) is provided in this standard because of the standard's focus on control objectives as a specific measure for determining whether a material weakness continues to exist. This is consistent with the Board's objective for its standards to be clear as well as the focus on control objectives in the engagement described by this standard.

B35. The Board believes that the standard's focus on control objectives is sound and helpful and is an appropriate complement to the control criteria, such as

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[6] For example, paragraph 12 of Auditing Standard No. 2 states, "Therefore, effective internal control over financial reporting often includes a combination of preventive and detective controls to achieve a specific control objective." Paragraph 85 of Auditing Standard No. 2 elaborates on this idea, including the example that, when performing tests of preventive and detective controls, the auditor might conclude that a deficient preventive control could be compensated for by an effective detective control and, therefore, not result in a significant deficiency or material weakness. That paragraph concludes with the statement, "When determining whether the detective control is effective, the auditor should evaluate whether the detective control is sufficient to achieve the control objective to which the [deficient] preventive control relates." Perhaps most notably, paragraph 88 of Auditing Standard No. 2 requires the auditor to identify the company's control objectives in each area and identify the controls that satisfy each control objective to evaluate whether the company's internal control over financial reporting is designed effectively.

COSO, for the purposes of this engagement. The process of tailoring control objectives to the individual company allows the control criteria (i.e., the evaluation framework) used for management's annual assessment to be applied to the facts and circumstances in a reasonable and appropriate manner. Accordingly, the emphasis in this standard on control objectives is consistent with, and supports a correct application of, COSO.

B36. The focus on whether the stated control objectives have been met as the target for determining whether a material weakness continues to exist does accommodate the circumstance in which a deficiency or significant deficiency continues to exist in that area of the company's internal control over financial reporting. Although several commenters linked this result with the focus on control objectives, this potential result would exist in any case within the overall construct of this standard, completely apart from the focus on control objectives. The potential for less severe deficiencies to persist in an area in which a previously reported material weakness no longer exists parallels the reporting results of an engagement performed under Auditing Standard No. 2. According to that standard, only material weaknesses (not less severe weaknesses) are disclosed in an auditor's report and only the existence of a material weakness and not less severe weaknesses affects the auditor's opinion on the effectiveness of the company's internal control over financial reporting. As an illustration, assume that a company that had previously reported a material weakness in internal control over financial reporting elected to wait until the auditor's next annual report issued pursuant to Auditing Standard No. 2 to obtain auditor assurance related to the existence of the material weakness. If the control weakness that had previously risen to the level of material weakness were reduced to a significant deficiency or deficiency as of the company's next year-end, the auditor's next report issued under Auditing Standard No. 2 would present an unqualified opinion indicating that the company's internal control over financial reporting was effective. The Board concluded that the users of an auditor's report on whether a previously reported material weakness continues to exist need only receive auditor assurance that the material weakness no longer exists and not more detailed information about whether less severe control deficiencies continue to persist.

B37. The Board notes, however, that paragraph 140 of Auditing Standard No. 2 states (in part) that strong indicators of a material weakness include circumstances in which significant deficiencies that have been communicated to management and the audit committee remain uncorrected after some reasonable period of time. If management does not plan to correct the significant deficiency within a reasonable period of time, the auditor should evaluate whether the remaining significant deficiency could be indicative of a material weakness in internal control over financial reporting. An auditor is not required to provide an opinion under this voluntary engagement, and could reasonably decline to provide an opinion under such circumstances.

B38. In response to comments that report users will mistakenly believe that an auditor's report issued pursuant to the standard's provisions is communicating auditor assurance that no control deficiencies exist in the area related to the former material weakness, the Board decided that the change in the title of the standard and the form of the auditor's opinion (discussed further in paragraph B14), coupled with this discussion, would sufficiently mitigate any potential for report users to misunderstand the assurance being provided by an engagement conducted under the this standard. Removing the concept of control objectives from the standard would not address the potential for misunderstanding because this potential exists independently of the focus on control objectives.

B39. With regard to the recommendation that the standard provide additional examples of stated control objectives, including stated control objectives related to components of internal control over financial reporting other than control activities, the Board determined that the provisions of the standard should remain largely at the conceptual level and state that the other components of internal control over financial reporting can be expressed in terms of control objectives. The Board also determined to emphasize, in the note to paragraph 17 of the standard, that when a material weakness has a pervasive effect on the company's internal control over financial reporting, it may be difficult to identify all of the relevant control objectives and the material weakness probably is not suitable for this type of narrow, interim reporting.

B40. For the purposes of this engagement, a stated control objective need not be more precise than to describe an objective that relates to whether there is a more than remote risk that the company's financial statements are materially misstated in a given area. For instance, paragraph 14 of the standard includes the example control objective, "The company has legal title to recorded product X inventory in the company's Dallas, TX warehouse." This example assumes that the product X inventory account related to the company's Dallas, TX warehouse represents a more than remote risk of material misstatement to the company's financial statements taken as a whole and has been identified as a separate significant account. This example does not suggest that a company should establish separate control objectives for all of its various types of inventory, by inventory location, regardless of materiality.

B41. Although the Board believes that the proposed standard made clear that in performing this engagement, the auditor should identify and test all controls necessary to achieve the stated control objective, based on the importance of this concept and in response to commenters, the Board concluded that an explicit clarification should be added. Not only must newly implemented or modified controls be identified and tested in this engagement, but *all* controls necessary to achieve the stated control objective must be identified and tested. For example, in a circumstance in which four controls must operate effectively for a given control objective to be achieved, the failure of one of those controls could result in a material weakness. In the context of this engagement, all four controls necessary to achieve the stated control objective would need to be specifically identified and tested. This must be the case because of the inherent limitations in internal control over financial reporting. If three of the four controls were found to be effective as of year-end, they cannot be assumed to be effective as of a later date. To render an opinion as of a current date about whether the material weakness exists, the auditor must have current evidence about whether all controls (in this example, all four controls) necessary to achieve the control objective are designed and operating effectively.

B42. Regarding the suggestion to include a requirement that control objectives be documented, the Board notes that neither COSO nor Auditing Standard No. 2 currently contain such a requirement. As with many aspects of assessing the effectiveness of internal control over financial reporting, the better the documentation, the easier and more efficient the evaluation, especially from the auditor's perspective. In the context of this engagement, by virtue of creating a stated control objective, the company and the auditor would document the stated control objective, even if that documentation appeared only in their respective reports. Therefore, documentation is effectively required for the stated control objectives encompassed by an engagement conducted under this standard. The Board does not believe, however, that establishing a broad requirement for documenting *all* control objectives related to a company's internal control over financial reporting is needed at this time or would be appropriately placed within this standard.

Concept of Materiality

B43. To provide direction on the concept of materiality, the proposed standard largely referred to Auditing Standard No. 2. The proposed standard stated that the concept of materiality, as discussed in paragraphs 22 and 23 of Auditing Standard No. 2, underlies the application of the general and fieldwork standards in an engagement to report on whether a previously reported material weakness continues to exist. Therefore, the auditor uses materiality at the financial-statement level, rather than at the individual account-balance level, in evaluating whether a material weakness exists.

B44. Several auditors commented that the proposed standard should provide additional direction on how the auditor considers materiality in performing this engagement. Commenters believed that clarification was necessary regarding the appropriate time context for management's and the auditor's materiality judgments. These commenters asked whether materiality should be assessed as of the date management asserts to be the date at which the material weakness no longer exists, or as of the end of the prior year when the material weakness was originally reported.

B45. Most commenters on this issue suggested that the date for assessing materiality should be the date management asserts to be the date at which the material weakness no longer exists. Commenters noted, however, that this position would allow a material weakness to no longer exist merely as a result of a business acquisition or disposition, for example, because either of those actions would change materiality as of that point in time (and, in the case of a disposition, send the material weakness along with the disposed business).

B46. Several auditors suggested that the auditor's opinion should explicitly recognize the concept of materiality. Commenters suggested the following as alternatives that would recognize materiality: "Management's assertion that XYZ Company has eliminated the material weakness described above as of [*date of management's assertion*] is fairly stated, in all material respects . . ." and "XYZ Company has eliminated the material weakness with respect to the Company's internal control over financial reporting as described above as of [*date specified in management's assertion*], in all material respects." These commenters were concerned that the opinion described by the proposed standard misrepresented the precision of the auditor's assessment and neglected the notion of reasonable assurance.

B47. The Board decided that the provisions in the standard regarding materiality should be clarified to specify that materiality should be assessed as of the date management asserts that the material weakness no longer exists. The as-of date of management's assertion and the auditor's opinion is fundamental to the auditor's decisions about whether he or she has obtained sufficient evidence to support an opinion and to the auditor's evaluation of that evidence to form an opinion on whether the material weakness exists as of that point in time. The Board believes that the logical and internally consistent position regarding the time context for assessing materiality is to assess materiality as of the date that management asserts the material weakness no longer exists. The Board also believes that materiality can be assessed as of a date other than a financial reporting period-end. This is consistent with the Board's decision, discussed further beginning at paragraph B15, that the standard permit the auditor to report on whether a previously reported material weakness continues to exist as of any date.

B48. The Board also believes that auditors should exercise caution in circumstances in which the only aspect of a previously reported material weakness that has changed is materiality (in other words, the size of the financial statement

accounts has changed due to an acquisition or other activity rather than any changes in the design or operation of controls). In many such cases, the company will have undergone significant changes, with an associated change in internal control over financial reporting overall. In this circumstance, the auditor would need to perform procedures beyond the scope of work ordinarily contemplated under this standard to have a sufficient basis for his or her new assessment of materiality and an adequate understanding of the company's internal control over financial reporting overall. The Board believes that, in many cases in which the company has undergone a change of this magnitude, the auditor would need to perform a full audit of internal control over financial reporting in accordance with Auditing Standard No. 2 to have a sufficient basis for assessing materiality, understanding the company's internal control over financial reporting overall, and rendering an opinion about whether a material weakness continues to exist. Also, as discussed in paragraph B37, a previously reported material weakness may no longer exist because it has been reduced to a significant deficiency. In this circumstance, if management does not plan to correct the significant deficiency within a reasonable period of time, the auditor should evaluate whether the remaining significant deficiency could be indicative of a material weakness.

B49. Regarding the form of the auditor's opinion and concerns that the opinion suggested by the proposed standard implied an inappropriate degree of precision and neglected the concept of reasonable assurance, the Board concluded that the provisions of the proposed standard were sufficiently clear that the auditor's objective in this engagement was to plan and perform the engagement to obtain reasonable assurance about whether a previously reported material weakness continues to exist as of the date specified by management. Furthermore, the auditor's report described by the proposed standard included disclosure of this objective. The Board does not, therefore, believe that report users would mistakenly believe that the auditor's opinion, as proposed, would convey absolute assurance.

B50. In addition, the Board believes that including another reference to materiality in the auditor's opinion would not add anything of substance to the auditor's conclusion and could instead impair its readability. The determination of whether a material weakness exists is inherently linked to materiality. Stating that the material weakness no longer exists in all material respects would be redundant—the equivalent of saying that the financial statements are not materially misstated in all material respects. Accordingly, the Board has not added another reference to materiality in the auditor's opinion.

Performance of Substantive Procedures

B51. The proposed standard, consistent with its reliance on the existing provisions of Auditing Standard No. 2, focused largely on the tests of controls that the auditor must perform to obtain reasonable assurance that a material weakness no longer exists. The proposed standard additionally recognized that, in some cases, the auditor also would need to perform substantive procedures on account balances to obtain sufficient evidence as to whether a material weakness no longer exists.

B52. Several auditors believed that the proposed standard was too mild in its wording that the auditor "may determine" that performing substantive procedures was necessary. Those commenters believed that, to be consistent with the integrated audit concept of Auditing Standard No. 2 and to reflect the fact that identification of many material weaknesses during the past year occurred during the performance of substantive audit procedures, such wording did not adequately convey the importance of performing substantive procedures in an

engagement to report on whether a previously reported material weakness continues to exist. Some commenters recommended that the standard set forth a presumptively mandatory requirement for the auditor to perform substantive audit procedures in all cases, while others suggested that strengthening the language or providing additional guidance about when substantive procedures are necessary would be sufficient.

B53. The Board continues to believe that in some circumstances, substantive procedures will not be necessary for the auditor to obtain sufficient evidence about whether a material weakness continues to exist. Like many aspects of this standard, the auditor's judgment in this area will depend on the nature of the material weakness. An auditor can obtain sufficient evidence to support an opinion on whether some material weaknesses continue to exist without the need for substantive procedures. Other material weaknesses necessitate substantive procedures for the auditor to obtain sufficient evidence. Therefore, the Board determined that it would be inappropriate to establish a presumptively mandatory requirement that substantive procedures be performed in all cases.

B54. The Board agreed, however, that the proposed standard did not sufficiently stress the potential importance of performing substantive procedures, depending on the nature of the material weakness. Paragraph 34 of the standard has, therefore, been modified in a manner that the Board believes better articulates the potential need to perform substantive procedures. An example also has been added to this paragraph of the standard to illustrate a circumstance in which substantive procedures ordinarily would need to be performed.

Using the Work of Others

B55. Similar to PCAOB Auditing Standard No. 2, the proposed standard permitted the auditor to use the work of others to alter the nature, timing, and extent of the auditor's performance of this work. Specifically, the proposed standard applied the framework for using the work of others described in PCAOB Auditing Standard No. 2. That framework requires the auditor to obtain the principal evidence supporting his or her opinion and to evaluate the nature of the controls being tested, together with the competence and objectivity of the persons performing the work.

B56. Under both PCAOB Auditing Standard No. 2 and the proposed standard, the framework measures principal evidence in relation to the overall assurance provided by the auditor. In PCAOB Auditing Standard No. 2, the principal evidence supporting the auditor's opinion should be evaluated in relation to the auditor's opinion on internal control over financial reporting overall. In contrast, the evaluation of whether the auditor has obtained the principal evidence supporting his or her opinion as to whether a material weakness no longer exists would need to be applied at the control objective level.

B57. There were few comments on the provisions for using the work of others in this proposed standard. Most commenters who commented on these provisions expressed confusion about a passage in the example of proposed paragraph 36, which stated that "the auditor *might* perform a walkthrough of the reconciliation process himself or herself [emphasis added]." Commenters believed that walkthroughs were required in the proposed standard in all cases and that walkthroughs must be conducted by the auditor himself or herself.

B58. One auditor suggested clarifying within the proposed standard that the auditor will be able to use the work of others only in limited circumstances. This same commenter also believed that the bank reconciliation example presented in the proposed standard to illustrate how the auditor could use the work of others in this type of engagement was too simplistic and requested additional, more realistic examples.

B59. The Board continues to believe that the framework for using the work of others that was established in Auditing Standard No. 2 is appropriate for use in this context and, therefore, the provisions for using the work of others in the standard have been retained as proposed. At the same time, the Board determined that it would be helpful to clarify, through the following discussion, that the evaluation of whether the auditor has obtained the principal evidence supporting his or her opinion on whether a material weakness continues to exist would need to be applied at the control objective level. A complete understanding of this feature of the standard is important because this provision allows for additional flexibility in the auditor's work.

B60. The auditor's opinion in this engagement is expressed only on whether the material weakness continues to exist—not on whether the individually identified controls are effective. As a result, the evaluation as to whether the auditor has obtained the principal evidence supporting his or her opinion should be made at the control objective level—not at the lower level of the controls individually identified in management's assertion and the auditor's report.

B61. If, for example, management's and the auditor's reports identify three separate previously reported material weaknesses that no longer exist, the auditor would, in effect, be rendering three separate opinions. Those opinions would indicate that each of the three individual material weaknesses continues to exist or no longer exists as of the date of management's assertion. The standard, therefore, would require the auditor to obtain the principal evidence that the *control objectives* related to each of the three identified material weaknesses were now achieved. However, the standard would not require that the auditor obtain the principal evidence that each *control specifically identified* in management's assertion as achieving the control objectives is effective.

B62. Auditing Standard No. 4 follows the same framework for using the work of others as Auditing Standard No. 2. There may, however, be some circumstances in which the scope of the audit procedures to be performed in this engagement will be so limited that using the work of others will not provide any tangible benefit to the company or its auditor. The Board believes that no additional specific restriction on the use of the work of others is appropriate or necessary in the context of this engagement. Such a restriction would diminish the flexibility that the framework otherwise provides and perhaps inhibit the auditor's exercise of the judgment necessary to implement the framework appropriately. Furthermore, the Board does not believe that auditors need such direction within the standard to make appropriate decisions about using the work of others in this context.

B63. Similarly, the Board determined that no further examples of using the work of others were needed. The Board believes that additional examples demonstrating the application of the provisions in the standard for using the work of others to reflect more realistic (i.e., complex, fact-driven) situations is better handled outside of the standard itself and by auditors—in their audit methodology, training courses, and other venues.

B64. In response to confusion about the requirement for walkthroughs, the Board clarified the standard by adding a note to paragraph 38 and deleted the reference to a walkthrough from the example on using the work of others. Walkthroughs are required only of a successor auditor when the successor auditor performs this engagement before performing an audit of internal control over financial reporting in accordance with Auditing Standard No. 2. A continuing auditor that has opined already on the company's internal control over financial reporting in accordance with Auditing Standard No. 2 as of the company's most recent annual assessment and is engaged to conduct this narrow engagement is not required to perform any walkthroughs as part of this engagement.

Dividing Responsibility

B65. Due to the narrow scope of an engagement to report on whether a material weakness continues to exist, the provisions of the proposed standard allowed the principal auditor to use the work and reports of another auditor as a basis, in part, for his or her opinion. The proposed standard also prohibited the principal auditor from dividing responsibility for the engagement with another auditor.

B66. Very few comments were received on this provision of the proposed standard. One auditor suggested that, although dividing responsibility may not be appropriate in certain circumstances, the standard should not prohibit it. Another auditor expressed confusion about whether the principal auditor could refer to the report of the other auditor but not divide responsibility with the other auditor.

B67. The Board continues to believe that, based on the nature of the engagement described by the standard, the principal auditor should be prohibited from dividing responsibility for the engagement with another auditor. The Board's consideration of the nature of this engagement included recognition of the narrow scope of the work (i.e., whether a previously reported material weakness continues to exist), that the engagement would be voluntary, and that the assignment would be non-recurring (unlike the recurring nature of the audit of the financial statements or the audit of internal control over financial reporting). The Board notes that three appropriate alternatives exist in the circumstance in which another auditor is involved and the company wants to obtain auditor assurance that a previously reported material weakness no longer exists:

- The principal auditor could report on whether a previously reported material weakness continues to exist according to this standard by performing all of the testing required for this engagement himself or herself.
- The principal auditor could report on whether a previously reported material weakness continues to exist according to this standard by using the work and reports of another auditor as a basis, in part, for his or her opinion, and by taking responsibility for the work performed by the other auditor. In this case, the auditor may not make reference to the other auditor in his or her report on whether a previously reported material weakness continues to exist.
- The company could wait until year-end when the principal auditor would report on the effectiveness of internal control over financial reporting overall under the provisions of Auditing Standard No. 2.

B68. The Board concluded that the standard was sufficiently clear that the principal auditor could not divide responsibility with another auditor and, therefore, that the auditor also could not refer to the other auditor in his or her report. Accordingly, no change has been made to the standard in this regard.

New Material Weaknesses Identified

B69. The proposed standard was silent regarding the auditor's responsibilities if, during the performance of this engagement, he or she became aware of a new material weakness not previously reported on by an auditor.

B70. Several commenters requested that the standard address the auditor's responsibilities for new material weaknesses identified during this engagement and suggested what these responsibilities should be. One investor suggested that the standard should require the auditor to include disclosure of any new material weaknesses of which the auditor was aware in his or her report. This

commenter stated that, otherwise, the auditor's report would become a way of telling investors the good news while concealing the bad news. Another commenter suggested that management should be required to include the new material weakness in management's assertion that would accompany the auditor's report and the auditor should then disclaim an opinion on the new material weakness.

B71. Both the identification of material weaknesses and the remediation of such weaknesses will be captured by management's voluntary and required reporting under the SEC's rules. Accordingly, the provisions of this standard do not facilitate management's ability to conceal from investors the emergence of a new material weakness at the company. Nevertheless, the Board agreed that when an auditor identifies a new material weakness during the performance of this engagement, the auditor should not simply remain silent. Accordingly, the Board modified the standard to require the auditor to communicate, in writing, to the audit committee any material weaknesses identified during this engagement that the auditor had not previously communicated, in writing, to the audit committee.

B72. The existing provisions of Auditing Standard No. 2 contain responsibilities for the auditor if (1) information comes to the auditor's attention during this engagement that leads him or her to believe, while performing quarterly procedures required by Auditing Standard No. 2, that management's quarterly disclosures are materially misleading, or (2) the auditor becomes aware of conditions that existed at the date of his or her last report issued under Auditing Standard No. 2.

B73. Paragraphs 202-206 of Auditing Standard No. 2 establish certain requirements for the auditor related to management's quarterly and annual certifications with respect to the company's internal control over financial reporting. If matters come to the auditor's attention during this engagement that lead him or her to believe, while fulfilling these quarterly requirements, that modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of Section 302 of the Act and the SEC's rules, these provisions of Auditing Standard No. 2 require the auditor to take action. Such actions escalate from auditor communications with management and then to the audit committee, culminating in the auditor considering his or her additional responsibilities under AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.

B74. In addition, a continuing or predecessor auditor would have responsibilities under paragraph 197 of Auditing Standard No. 2 if the existence of a new material weakness came to the auditor's attention. This paragraph effectively extends the responsibilities in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, to reports on the effectiveness of internal control over financial reporting issued pursuant to Auditing Standard No. 2. The identification of a new material weakness in the current year would cause the auditor, in fulfilling these responsibilities, to determine whether the facts relating to the material weakness existed at the date of the auditor's report pursuant to Auditing Standard No. 2 and, if so, (1) whether those facts would have changed the auditor's report issued under Auditing Standard No. 2 if he or she had been aware of them and (2) whether there are persons currently relying on or likely to rely on the auditor's report. If the auditor determined that the new material weakness identified in the current year actually existed as of the date of his or her previous report under Auditing Standard No. 2 and that it was not adequately identified and disclosed in that report, the auditor would need

to take steps such as recalling and reissuing the previous report to ensure that investors did not continue to rely on the previously issued (erroneous) report.

B75. Including newly identified material weaknesses in the auditor's report could potentially mislead investors into believing that the assurance provided by this type of engagement is broader than it actually is. If report users were provided with disclosure (covered by the auditor's opinion) of new material weaknesses of which the auditor was aware, report users might incorrectly believe that the auditor's report captured *all* new material weaknesses that had arisen at the company. Similarly, a requirement for the auditor to disclose any new material weaknesses could lead report users to conclude, incorrectly, that no such disclosure means that there is current auditor assurance over the whole of internal control over financial reporting at the company. The objective of this engagement is to provide auditor assurance about whether a previously reported material weakness continues to exist—nothing broader. The only way for investors to obtain a more complete report from the auditor would be for the auditor to audit internal control over financial reporting in accordance with Auditing Standard No. 2.

Specific Identification of All Previously Reported Material Weaknesses

B76. The proposed standard required the auditor to modify his or her report if the auditor provides assurance on less than all of the material weaknesses previously reported. The proposed standard did not, however, require the auditor to specifically identify all of the previously reported material weaknesses not covered.

B77. All investors who commented on this issue suggested that all material weaknesses previously reported either should be referred to or specifically included in the auditor's report. They indicated that failure to identify the additional material weaknesses might lead some users to erroneously conclude that they no longer exist. Auditors, on the other hand, agreed that complete specific identification of the previously reported material weaknesses not covered by the auditor's opinion should not be included, primarily because they believe that it may increase the risk of confusion about the scope of the engagement and what is being covered in the auditor's opinion. Several commenters who agreed that specific identification was not necessary suggested that in addition to the report modification included in the proposed standard, the auditor's report on this engagement should specifically direct the reader to the previous auditor's report (issued under Auditing Standard No. 2), by either attaching a copy of the audit report or by providing direction as to where the report could be obtained.

B78. The Board believes that including a complete specific identification of the previously reported material weaknesses not covered by this engagement would prove problematic. As noted by many commenters, it is possible that including this detail would confuse report readers regarding the scope of this narrow engagement and could simply that, unless told otherwise, a report user should assume that those other material weaknesses *do* continue to exist. In some of the material weakness descriptions included in management's and the auditor's reports on the effectiveness of the company's internal control over financial reporting as of year-end, the description of multiple material weaknesses covered several pages. That level of detail in an auditor's report specifically targeted at whether just one material weakness continues to exist could easily overwhelm the rest of the audit report, making the report prone to various kinds of misinterpretations.

B79. The Board concluded that report readers would be better served by requiring the auditor to provide information regarding where to obtain the previously

issued audit report—either by attaching it or referring to where it could be publicly obtained.

Other Reporting Matters

B80. *No Requirement to Issue a Report.* The proposed standard required that the auditor, if he or she concluded that the material weakness continues to exist, communicate that conclusion in writing to the audit committee. The proposed standard, however, did not require the issuance of a report. Rather, the proposed standard recognized that the auditor must consider this knowledge in connection with the auditor's responsibilities under Auditing Standard No. 2 to determine whether management's quarterly disclosures about internal control over financial reporting are not materially misleading.

B81. Several auditors who commented recommended that the proposed standard should require the auditor to issue an adverse report in the event that the auditor concludes that the material weakness continues to exist. One suggested that issuance of an adverse report would be necessary only if the auditor believed that the company had previously publicly disclosed that the material weakness had been addressed.

B82. The Board continues to believe that requiring the issuance of an adverse report to the company would serve no useful purpose in this circumstance because the company might not make such a report public. The Board believes, therefore, that requiring the auditor to communicate, in writing, with the audit committee his or her conclusion that a material weakness that was the subject of this engagement continues to exist would serve the same purpose as requiring the issuance of an adverse report. At the same time, such a requirement would provide the auditor with additional flexibility as to the form of communication that would be most meaningful to the audit committee. Regarding the potential for management to lead investors to incorrectly believe that the material weakness no longer exists in its public disclosures, the Board believes that the federal securities laws, as well as auditor's existing responsibilities related to management's quarterly disclosures, are adequate safeguards to protect investors from misleading information.

B83. *No Distinction in Standard Between Unqualified and Adverse Opinion.* As discussed in the note to paragraph 43 of the standard, the standard no longer distinguishes between an unqualified and an adverse opinion. The auditor's opinion was revised to state that the material weakness exists or no longer exists. This revision is discussed further in the section "Form of Auditor's Opinion" and is now referred to in the standard as the auditor's opinion.

B84. *Inherent Limitations.* The inherent limitations paragraph of the auditor's report provided in the proposed standard discussed the inherent limitations of internal control over financial reporting overall, rather than the inherent limitations of the controls related to the material weakness being reported on.

B85. One commenter suggested that the inherent limitations paragraph was too broad for this engagement and needed to be modified to more accurately reflect the narrow focus of this type of engagement.

B86. The Board agreed that the inherent limitations paragraph, in this context, should be targeted to the specific controls identified in this auditor report. In addition, the Board continues to believe that the broader concept of inherent limitations in internal control over financial reporting overall is equally applicable. The inherent limitations paragraph in the auditor's report has been modified to reflect both of these conclusions.

B87. *Obtaining an Understanding of Internal Control Over Financial Reporting.* The proposed standard included a required report element stating that

"the engagement includes obtaining an understanding of internal control over financial reporting, examining evidence supporting management's assertion, and performing such other procedures as the auditor considered necessary in the circumstances." This language also was included in the example report included in the proposed standard.

B88. Several auditors expressed concern that the phrase, "the engagement includes obtaining an understanding of internal control over financial reporting," implies that, as a part of the current engagement, the auditor spent a significant amount of time understanding internal control over financial reporting overall rather than carrying forward his or her understanding from the prior annual audit. These commenters believed this implication conflicted with the direction in the body of the proposed standard that an auditor who has audited the company's internal control over financial reporting within the past year in accordance with Auditing Standard No. 2 would be expected to have obtained a sufficient knowledge of the company and its internal control over financial reporting to perform this engagement. One commenter acknowledged that the proposed wording may be appropriate in cases in which a successor auditor is performing this engagement without previously gaining that understanding.

B89. The Board continues to believe that an auditor who has audited the company's internal control over financial reporting as of the company's most recent annual assessment in accordance with Auditing Standard No. 2 would be expected to have obtained a sufficient knowledge of the company and its internal control over financial reporting to perform an engagement to report on whether a previously reported material weakness continues to exist. To require a continuing auditor to update and document his or her understanding of internal control over financial reporting overall (to the full measure required by Auditing Standard No. 2) would be unnecessarily burdensome and costly. The Board modified the report element for a continuing auditor to clarify that the auditor previously obtained an understanding of internal control over financial reporting overall at the company and updated that understanding as it specifically relates to changes in internal control over financial reporting associated with the specified material weakness.

B90. The Board continues to believe, however, that a successor auditor that has not yet audited the company's internal control over financial reporting in accordance with Auditing Standard No. 2 would need to obtain a current understanding of internal control over financial reporting in connection with this engagement. Therefore, the report element described in the proposed standard is appropriate and has been retained for a successor auditor's reporting.

B91. *Example Reports.* The proposed standard included only one example report, which illustrated reporting on one material weakness by a continuing auditor when no additional material weaknesses were reported previously. Several commenters requested modification of the standard to address circumstances that the Board believed were already addressed by the proposed standard but were not illustrated in the single example report. Some commenters also made specific requests for additional example reports.

B92. The Board determined, after considering the nature of the comments, that additional example reports, while not covering all possible situations, would provide additional clarity to the various reporting situations. The Board selected three reports to illustrate most facets of the reporting provisions of the standard. Appendix A includes those reports.

Conforming Amendments to AT sec. 101

B93. The proposed standard contained a proposed conforming amendment to AT sec. 101, *Attest Engagements*. The proposed conforming amendment would

have required the proposed standard to be used, rather than AT sec. 101, for any engagements in which the subject matter is whether a material weakness continues to exist. This conforming amendment would have precluded the auditor from performing an agreed-upon procedures or review engagement (using AT sec. 101) when the subject matter of the engagement was whether a material weakness continues to exist.

B94. The Board received few comments related to the proposed conforming amendment. One auditor agreed that a conforming amendment to preclude a review-level attestation was appropriate when the subject matter was whether a material weakness continues to exist. This commenter went on to suggest, however, that there could be appropriate uses for an agreed-upon procedures engagement and that the Board should not preclude agreed-upon procedures from being performed under the Board's standards. Such reports, the commenter noted, would be restricted to the use of the specified parties who take responsibility for the sufficiency of the agreed-upon procedures for their purposes and, therefore, these reports would not generally be available to investors. Thus, these reports would not be a substitute for the engagements addressed in the proposed standard. Another commenter separately suggested broadly retaining the ability for the auditor to perform a review engagement when the subject matter is a previously reported material weakness.

B95. The Board continues to believe that investors and other report users in the public domain will be best served by the Board's standards permitting only positive assurance (i.e., an examination-level attestation) from the auditor when the subject matter is whether a material weakness continues to exist. The Board agrees, however, that private parties (such as audit committees) who wish to engage the auditor to perform specified procedures when the subject matter is whether a material weakness continues to exist should be allowed to negotiate such a private arrangement, as long as the results are not intended for public use. The Board, therefore, decided to modify the conforming amendment to AT sec. 101 of the Board's interim standards. As adopted, an auditor may not use AT 101 to report on whether a material weakness in internal control over financial reporting continues to exist for any purpose other than the company's internal use.

Appendix 2

Conforming Amendment to PCAOB Auditing and Related Professional Practice Standards Resulting From the Adoption of the Auditing Standard No. 4—*Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

Attestation Standards

The Board's interim attestation standards include the Statements on Standards for Attestation Engagements promulgated by the ASB, as in existence on April 16, 2003. The conforming amendment to the Board's interim attestation standards is as follows:

- *AT sec. 101, Attest Engagements*

  AT sec. 101 is amended by adding as letter f. to paragraph .04, the following:

  Engagements in which the practitioner is engaged to report on whether a material weakness in internal control over financial reporting continues to exist for any purpose other than the company's internal use. Such engagements must be conducted pursuant to PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*.

PCAOB Release No. 2005-020

Ethics and Independence Rule Concerning Independence, Tax Services, and Contingent Fees

PCAOB Release No. 2005-020
November 22, 2005

PCAOB Rulemaking
Docket Matter No. 017

Approved by the Securities and Exchange Commission on April 19, 2006, with varying effective dates.

The Securities and Exchange Commission has approved PCAOB ethics and independence rules concerning independence, tax services and contingent fees.

The rules introduce a foundation for the independence component of the Board's ethics rules by establishing a general obligation requiring a registered public accounting firm and its associated persons to be independent of the firm's audit clients throughout the audit and professional engagement period.

The rules identify circumstances in which the provision of tax services impairs an auditor's independence, including services related to marketing, planning, or opining in favor of the tax treatment of, among other things, transactions that are based on aggressive interpretations of applicable tax laws and regulations.

The rules also treat registered public accounting firms as not independent of their audit clients if they enter into contingent fee arrangements with those clients or if the firms provide tax services to certain members of management who serve in financial reporting oversight roles at an audit client or to immediate family members of such persons.

The rules further implement the Sarbanes-Oxley Act's requirement that auditors' non-audit services be pre-approved by the audit committee by strengthening the auditor's responsibilities in connection with seeking audit committee pre-approval of tax services. Specifically, the rules require a registered public accounting firm that seeks such pre-approval to describe proposed tax services engagements, in writing, for the audit committee; to discuss with the audit committee the potential effects of the services on the firm's independence; and to document the substance of that discussion.

Finally, an ethics rule also codifies the principle that persons associated with a registered public accounting firm (e.g., individual accountants) can be held responsible when certain of their actions contribute to a firm's violation of relevant laws, rules, or professional standards.

The effective dates for the rules follow:

Rule	Effective Date
3501—Definition of Terms	April 29, 2006
3502—Responsibility Not to Knowingly or Recklessly Contribute to Violations	April 29, 2006
3520—Auditor Independence	April 29, 2006
3521—Contingent Fees	Rule 3521 will not apply to contingent fee arrangements that were paid in their entirety, converted to fixed fee arrangements, or otherwise unwound before June 18, 2006.
3522—Tax Transactions	Rule 3522 will not apply to tax services that were completed by a registered public accounting firm no later than June 18, 2006.
3523—Tax Services for Persons in Financial Reporting Oversight Roles	Rule 3523 will not apply to tax services being provided pursuant to an engagement in process on April 19, 2006, provided that such services are completed on or before October 31, 2006.
3524—Audit Committee Pre-approval of Certain Tax Services	Rule 3524 will not apply to any tax service pre-approved on an engagement-by-engagement basis before June 18, 2006. With respect to tax services provided to audit clients whose audit committees pre-approve tax services pursuant to policies and procedures, Rule 3524 will not apply to any such tax service that is begun by April 20, 2007.

Summary:

The Public Company Accounting Oversight Board ("PCAOB" or "Board") is adopting technical amendments to certain rules it adopted in July 2005 to promote the ethics and independence of registered public accounting firms that audit financial statements of U.S. public companies.

Public Comments:

The Board, on December 14, 2004, released for public comment proposed rules to promote the ethics and independence of registered public accounting firms. The Board received 807 letters of comment. After considering these comments, the Board adopted final rules on July 26, 2005. Because the amendments being adopted today do not change the substance of these rules, the Board is not seeking additional comment. The rules adopted on July 26, 2005, as amended by this release, remain subject to the Securities and Exchange Commission ("SEC") approval process, which includes a period for public comment.

Board Contacts:

Bella Rivshin, Assistant Chief Auditor (202/207 -9180; rivshinb@pcaobus.org), or Greg Scates, Associate Chief Auditor (202/207 -9114; scatesg@pcaobus.org).

* * *

On July 26, 2005, the Board adopted certain rules related to registered public accounting firms' provision of tax services to public company audit clients. The rules were designed to address certain concerns related to auditor independence when auditors become involved in marketing or otherwise opining in favor of aggressive tax shelter schemes or in selling personal tax services to individuals who play a direct role in preparing the financial statements of public company audit clients. As part of this rulemaking, the Board adopted an ethics rule, Rule 3502, to codify the principle that persons associated with a registered public accounting firm should not cause the firm to violate relevant laws, rules, and standards. The rules were submitted to the SEC on August 2, 2005, for its approval, pursuant to Section 107 of the Sarbanes-Oxley Act of 2002.

After discussions with the SEC, the Board has decided to remove the word "cause" from the title and text of Rule 3502. This amendment is intended to avoid any misperception that the rule affects the interpretation of any provision of the federal securities laws. The rule, as amended, should be interpreted and understood to be the same as the rule adopted by the Board in July, however.[1] In particular, under the amended rule, the person's conduct must have the same relation to the violation and the person must act with the same mental state as under the rule the Board adopted in July.

The Board is also amending Note 1 to Rule 3522(b) to correct a typographical error in the citation of the provision of the Internal Revenue Code cited in that note.

In light of the time that has elapsed since their adoption, the Board has also decided to revise the effective dates for certain of the rules. Three of those rules—Rules 3521, 3522 and 3524—had effective dates of the later of December 31, 2005 or 10 days after the date the SEC approves the rules.[2] The Board has decided to revise the effective dates of those three rules to 60 days after the date the SEC approves the rules.[3]

Specifically, the Board will not apply Rule 3521 to contingent fee arrangements that were paid in their entirety, converted to fixed fee arrangements, or otherwise unwound before 60 days after the date that the SEC approves the rules.[4] The Board will not apply Rule 3522 to tax services that were completed by a registered public accounting firm no later than 60 days after the date that the SEC approves the rules. Rule 3524 will not apply to any tax service pre-approved before 60 days after the date that the SEC approves the rules, or, in the case of an issuer that pre-approves non-audit services by policies and procedures, the rule will not apply to any tax service provided by March 31, 2006. Combined with the time period since the rules' adoption, the extension of the effective dates for these rules should allow reasonable time for affected firms to

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[1] See PCAOB Release No. 2005-014 (July 26, 2005), at 9–14 (discussing Rule 3502).

[2] See id., at 47–48.

[3] The effective dates of Rules 3501, 3502, 3520 and 3523 are not changed by this release and remain as set forth in the Board's adopting release. Id.

[4] Of course, the Commission's Rule 2-01 on auditor independence treats an auditor as not independent if it enters into a contingent fee arrangement with an audit client today. 17 C.F.R. § 210.2-01 (c)(5).

prepare internal policies and procedures, train their employees to ensure compliance with the new requirements, and, if necessary, terminate or complete any ongoing engagements covered by the rules in a professional manner.

* * *

On the 22nd day of November, in the year 2005, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/
J. Gordon Seymour
Acting Secretary
November 22, 2005

APPENDIX—

Technical Amendments to Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees

Appendix

Amendments to Rules

[Underlining indicates an addition; strikethrough indicates a deletion.]

Rule 3502. Responsibility Not to ~~Cause~~ Knowingly or Recklessly Contribute to Violations

A person associated with a registered public accounting firm shall not take or omit to take an action knowing, or recklessly not knowing, that the act or omission would directly and substantially contribute to a violation by that registered public accounting firm of ~~cause that registered public accounting firm to violate~~ the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards~~; due to an act or omission the person knew, or was reckless in not knowing, would directly and substantially contribute to such violation~~.

Rule 3522. Tax Transactions.

* * *

(b) **Aggressive Tax Position Transactions—**that was initially recommended, directly or indirectly, by the registered public accounting firm and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws.

Note 1: With respect to transactions subject to the United States tax laws, paragraph (b) of this rule includes, but is not limited to, any transaction that is a listed transaction within the meaning of 26 C.F.R. §1.6011-~~1–4~~(b)(2).

* * *

PCAOB Release No. 2007-001

Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud

PCAOB Release No. 2007-001
January 22, 2007

This report focuses on aspects of the Board's interim auditing standards that address the auditor's responsibility with respect to fraud, principally AU § 316, *Consideration of Fraud in a Financial Statement Audit*.[1] The Board is not, in this report, changing or proposing to change any existing standard, nor is the report meant to provide a new interpretation of any aspect of existing standards. The Board has, however, identified certain observations, made in the course of Board inspections, that are sufficiently important or arise with sufficient frequency to warrant discussion in a public report, both for the purpose of generally focusing auditors on being diligent about these matters and for the purpose of providing information that audit committees may find useful in working with auditors.[2]

The auditor's responsibility with respect to the detection of a material misstatement caused by fraud is an important focus of the Board. The Board's standards state that the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, including misstatements caused by fraud.[3] Although any financial statement audit entails some risk that the auditor will not detect a material misstatement even when the audit has been conducted in accordance with the standards of the PCAOB,[4] the risk of nondetection is likely to be higher for misstatements caused by fraud than for misstatements caused by error, since fraud usually involves deliberate concealment and may involve collusion with third parties. The auditor should, therefore, assess risks and apply procedures directed specifically to the detection of a material, fraudulent misstatement of the financial statements.

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[1] On April 16, 2003, the Board adopted certain pre-existing auditing standards as its interim auditing standards to be used on an initial, transitional basis. PCAOB Rule 3200T describes the auditing standards that the Board adopted and requires registered public accounting firms and their associated persons to comply with these auditing standards to the extent not superseded or amended by the Board. See www.pcaobus.org/standards.

[2] The inspection observations described in this report reflect information reported to the Board by its inspection staff and do not reflect or constitute any determinations by the Board as to whether any firms or persons have engaged in any conduct for which the Board could sanction them through the Board's disciplinary process.

[3] See paragraph .01 of AU §316, *Consideration of Fraud in a Financial Statement Audit*.

[4] See AU § 316.12.

Using observations from certain Board inspections as a focal point, this report discusses aspects of procedures relevant to an auditor's consideration of fraud.[5] The discussion is organized around the following topics:[6]

- Auditor's Overall Approach to the Detection of Financial Fraud
- Brainstorming Sessions and Fraud-Related Inquiries
- Auditor's Response to Fraud Risk Factors
- Financial Statement Misstatements
- Risk of Management Override of Controls
- Other Areas to Improve Fraud Detection

Auditor's Overall Approach to the Detection of Financial Fraud

The auditor is to make various judgments about the nature, timing, and extent of tests to perform to address specifically identified risks of material misstatement due to fraud.[7]

PCAOB inspection teams have observed, however, that auditors often document their consideration of fraud merely by checking off items on standard audit programs and checklists. PCAOB standards require additional documentation evidencing the actual performance of certain of the procedures outlined in those programs and checklists.[8]

In addition, in audits performed by multi-person audit engagement teams, the lack of such additional documentation makes it difficult for senior members of the audit team to supervise engagement team members properly and to review the procedures performed with respect to the consideration of fraud. In certain instances involving such engagement teams, PCAOB inspection teams have observed that engagement teams' documentation did not contain any such additional evidence of the actual performance of the procedures, suggesting that there may not be sufficient involvement of senior members in supervising and reviewing the engagement team's application of the provisions of AU § 316.

In addition, PCAOB inspection teams have, in some cases, observed that auditors failed to expand audit procedures when addressing identified fraud risk factors. In those cases, it appeared that auditors might be performing the procedures required in AU § 316 mechanically, without using those procedures to develop insights on the risk of fraud or with a view toward identifying ways to modify the audit plan in order to address the risk. If used properly, firm programs and checklists can be useful tools for achieving the objectives of AU § 316. Mechanical implementation of the standard is unlikely to be very effective in detecting fraud.

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[5] Information received or prepared by the Board in connection with any inspection of a registered public accounting firm is subject to certain confidentiality restrictions set out in Sections 104(g)(2) and 105(b)(5) of the Act. Under the Board's Rule 4010, the Board may publish summaries, compilations, or general reports concerning the results of its various inspections, provided that no such published report may identify the firm or firms to which any quality control criticisms in the report relate.

[6] This report's focus on certain topics should not be understood to suggest any relatively lesser degree of importance of topics that are not addressed. Topics are included in this report because of the nature and frequency of deficiencies that Board inspectors have observed concerning these points in certain of their inspections.

[7] See AU § 316.52.

[8] See AU § 316.83 and paragraph 6 of PCAOB Auditing Standard No. 3, *Audit Documentation*.

Brainstorming Sessions and Fraud-Related Inquiries

The auditor's planning should include consideration of how the issuer's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how the issuer's assets could be misappropriated.[9] In audits involving multi-person audit teams, the audit team should hold what the standard refers to as a "brainstorming session" to discuss those issues. This discussion allows the audit team to be alerted to how fraud might be perpetrated and concealed based on the general and client-specific knowledge of key members of the audit team and the expertise of the more experienced members of the team. This brainstorming session also reinforces the concept that the detection of a material misstatement in the financial statements caused by fraud is an essential element of an audit.

During this stage of planning the audit, AU § 316.15 states the auditor should set "aside any prior beliefs the audit team members may have that management is honest and has integrity." The emphasis at this stage is on the issuer's vulnerability to fraud, if management and employees were inclined to perpetrate it,[10] and not solely on the likelihood that fraud has occurred. To be most effective, this stage of planning the audit, including an audit team's brainstorming discussion, should occur during the early stages of audit planning so that auditors can consider the issuer's vulnerability to fraud when developing an overall strategy for the expected scope and conduct of the audit. To most effectively identify fraud risk factors, an audit team's brainstorming session should involve key members of the audit team, including, for example, information technology ("IT"), tax, and other specialists, when they are key members of the audit engagement team.[11]

Despite the importance of this planning stage to an effective audit, PCAOB inspection teams have noted instances of failures to comply with this aspect of the standard. In particular, PCAOB inspectors have (1) identified audits in which the audit team was unable to demonstrate that brainstorming sessions were held; (2) identified audits in which the audit teams' brainstorming sessions occurred after planning and after substantive fieldwork had begun; and (3) identified audits in which key members of the audit team did not attend the brainstorming sessions.

To appropriately discharge the auditor's responsibility with respect to the detection of a material misstatement caused by fraud, the auditor should make inquiries of the audit committee, management, and others about their knowledge of alleged or suspected fraud and fraud risks within the organization.[12] In some engagements, however, inspection teams have found no evidence in the audit documentation that the auditor made required inquiries of the audit committee, management, or others about their knowledge of fraud and fraud risks.

Auditor's Response to Fraud Risk Factors

Auditors respond to the assessment of the risks of material misstatement due to fraud by using a combination of overall and specific responses.[13] The auditor

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[9] See AU § 316.14.

[10] See AU § 316.15.

[11] See AU § 316.17.

[12] See AU § 316.20–.27.

[13] See AU § 316.48.

should evaluate whether the fraud risk assessment can be linked to individual accounts or classes of transactions and related assertions.[14] Linking in this manner assists the auditor in designing the appropriate audit procedures.[15] An overall response involves a general consideration of how the audit is to be conducted and involves procedures such as modifying the assignment of personnel and the extent of supervision and incorporating an element of unpredictability into the selection of auditing procedures to be performed.[16] For specifically identified risks of material misstatement due to fraud, such as significant related-party transactions not in the ordinary course of business, the auditor generally responds by changing the nature, timing, and/or extent of auditing procedures.[17]

PCAOB inspection teams have observed instances of auditors failing to respond appropriately to identified fraud risk factors. Inspection teams also observed instances in which auditors examined transactions warranting further fraud risk consideration, but for which there was no evidence that the auditors had considered any associated fraud risk factors.

Financial Statement Misstatements

When the auditor's procedures identify misstatements in the financial statements, the auditor should document the nature and effect of the misstatements[18] and consider whether the misstatements might be indicative of fraud.[19] The auditor's evaluation of misstatements may influence the auditor's conclusion about the materiality of those misstatements.[20] Qualitative considerations related to indications of fraud may mean that misstatements of relatively small amounts are material.[21] Although intent might be difficult to ascertain, that difficulty does not relieve the auditor of the responsibility to consider whether misstatements might be indicative of fraud.[22] In addition, the auditor's ongoing assessment of the risk of material misstatement due to fraud should take into account, among other things, any last-minute adjustments significantly affecting financial results.[23]

PCAOB inspectors noted instances in which auditors failed to properly calculate planning materiality and/or the threshold for posting proposed audit adjustments to a summary schedule. As a result, certain uncorrected misstatements were not evaluated, or were not evaluated appropriately, both individually and in the aggregate, with other misstatements because the summary schedule was incomplete. The inspection teams also observed that some auditors did not fulfill their responsibility to investigate identified departures from generally accepted accounting principles to determine whether such departures were indicative of fraud.

In addition, PCAOB inspectors noted instances in which auditors did not post all proposed audit adjustments in excess of the posting threshold to the summary

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[14] See AU § 316.38.

[15] Ibid.

[16] See AU § 316.50.

[17] See AU § 316.52.

[18] See paragraph .40 of AU § 312, *Audit Risk and Materiality in Conducting an Audit*.

[19] See AU § 316.75.

[20] Ibid.

[21] See AU § 316.74–.75.

[22] See AU § 316.05–.12.

[23] See AU § 316.68.

schedule, thus rendering the summary incomplete. Inspectors also noted instances in which auditors had netted the effects of known misstatements that individually met the posting threshold. The net effect of those particular misstatements was lower than the posting threshold for the summary of unadjusted differences. As a result, those misstatements were improperly excluded from the evaluation of potential misstatements. Furthermore, inspection teams observed that some auditors did not adequately scrutinize late adjustments, significantly affecting financial results, that were proposed by management and that partially or completely offset adjustments previously proposed by the auditors.

Risk of Management Override of Controls

AU § 316.08 recognizes that "[m]anagement has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and to present fraudulent financial information. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively." To address the risk of management override of controls, AU § 316 requires an auditor to perform certain procedures, such as the examination of journal entries and other adjustments for evidence of possible material misstatements due to fraud[24] and the review of accounting estimates for biases that similarly could result in material misstatements due to fraud.[25]

PCAOB inspection teams noted instances in which it did not appear that the auditor had performed adequate procedures with respect to evaluating the risk of management override of controls. More specifically, in some instances it did not appear that the auditor had appropriately addressed the risk of management override of controls with respect to journal entries and accounting estimates.

Journal Entries

Management has often used journal entries to perpetrate or conceal fraudulent financial reporting by recording inappropriate or unauthorized amounts in the accounting records, including computer records, or by making adjustments directly to draft financial statements in post-closing or consolidating entries. Accordingly, auditors should understand the company's financial reporting process and the controls over journal entries and evaluate these areas.[26]

To identify, select, and test specific entries and other adjustments and to determine the appropriate method of examining the underlying support for these entries, auditors should consider several important issues, for example:

- Fraud risk factors that might help identify specific classes of journal entries for testing, such as entries made by unauthorized personnel or personnel who do not ordinarily enter journal entries, or entries that lack detailed explanations or other supporting documentation,
- The characteristics of fraudulent entries, including entries made at unusual times, such as nights, weekends, or holidays, and entries made to intercompany or suspense accounts, and

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[24] See AU § 316.58.

[25] See AU § 316.63.

[26] See AU § 316.58a.

- Nonstandard journal entries that might not be subjected to the same level of internal control as recurring journal entries, for instance, entries at the close of quarterly and annual reporting periods and those that are part of the post-closing process.[27]

PCAOB inspection teams identified certain audit engagements in which auditors performed tests of journal entries, but failed to demonstrate that they had appropriately assessed the completeness and integrity of the population of journal entries obtained from the issuer. The inspection teams also noted instances in which there was no evidence in the audit documentation, and no persuasive other evidence, that an appropriate examination and evaluation of journal entries was performed. In addition, inspection teams noted the exclusion of journal entries with lower dollar amounts from the examination. Setting the scope in such a manner fails to appropriately address the risk of fraud occurring as a result of the frequent use of low-dollar entries.

In reviewing journal entries, auditors should obtain an understanding of the financial reporting process related to the initiation, recording, and processing of journal entries;[28] the procedures used to record recurring and nonrecurring adjustments; and the controls over journal entries and similar adjustments. Auditors might need to use IT specialists and computer-assisted audit techniques to assist them in this process to ensure the integrity and completeness of the population of journal entries and to assist in the selection of journal entries for testing.[29]

Accounting Estimates

Fraudulent financial reporting often is accomplished through intentional misstatement of accounting estimates.[30] Financial frauds have been committed by management intentionally biasing assumptions and judgments used to estimate account balances. In certain cases, management also has used significant or unusual accounting estimates to intentionally distort results of operations by, for example, failing to recognize losses due to the impairment of assets or intentionally overstating estimates in one period so that the estimates can be reversed in future periods to manage earnings in those periods. Such accounting estimates include allowances for bad debts, accruals for merger-related expenses in connection with business combinations, and so-called restructuring reserves.

Auditors, in complying with AU § 316, should consider the possibility of management bias in developing estimates by considering whether the differences between the estimates best supported by the audit evidence and the estimates included in the financial statements indicate a possible management bias.[31] For example, if each individual accounting estimate included in the financial statements was reasonable and, at the same time, the effect of the difference between each management estimate and the estimate best supported by the audit evidence was to increase income, the auditor should reconsider the estimates taken as a whole.[32] Moreover, auditors should perform a retrospective

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[27] See AU § 316.61.

[28] See AU § 316.58–.59 and .61.

[29] See AU § 316.61.

[30] See AU § 316.63.

[31] Ibid.

[32] See AU § 312.36.

review of significant accounting estimates reflected in the prior year's financial statements to determine whether management's judgments and assumptions relating to estimates indicate a possible bias on the part of management.[33] If the auditor identifies a possible bias, he or she should evaluate whether the circumstances producing such a bias represent a risk of material misstatement due to fraud.[34]

PCAOB inspection teams observed that some auditors have failed to test, or failed to document their testing of, management's assumptions and other aspects of issuers' accounting estimates. The inspection teams also noted that some auditors failed to assess, or failed to include in their audit documentation evidence that they had assessed, whether the overstatement or understatement of accounting estimates indicated a bias in management's estimates that could result in material misstatements due to fraud.

Other Areas to Improve Fraud Detection

Improvement in auditors' performance in the areas described below also may better position auditors to detect possible misstatements due to fraud.[35]

Analytical Procedures

Although analytical procedures alone are not well-suited for detecting fraud,[36] they can be an effective diagnostic tool, depending on the reliability of the data used to develop the expected results. For example, auditors can use analytical procedures on information that management is less able or less likely to manipulate, such as operating statistics maintained by operating personnel or audited information.

PCAOB inspection teams have noted numerous deficiencies in auditors' performance of analytical procedures that were intended to be substantive analytical procedures. These deficiencies include the failure to test the underlying data used in the analytical procedures as well as the failure to disaggregate the data in order to improve the precision of the analytical procedures when such disaggregation was appropriate. In addition, inspection teams noted that, when the analytical procedures were intended to be substantive tests, some auditors failed to establish expectations, establish thresholds for identifying significant differences, or investigate differences from the expectations that were greater than the established thresholds. Moreover, some auditors failed to obtain corroboration of management's explanations for differences in excess of the established thresholds.

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[33] See AU § 316.64.

[34] See AU § 316.65.

[35] Each of the areas described in this section has significant relevance to aspects of an audit other than an auditor's responsibilities with respect to fraud. The discussion of any inspection observations in this section should not be understood to mean that any observed deficiencies in these areas have been addressed with the particular firm specifically in relation to detection of fraud. These matters are included in this report because appropriate attention to these areas may play a role in helping the auditor detect material misstatements caused by fraud.

[36] See paragraph .09 of AU §329, *Analytical Procedures*, as amended by the *Conforming Amendments to PCAOB Interim Standards Resulting From the Adoption of PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements."*

Confirmation Process

AU § 316.41 states that auditors ordinarily should presume that revenue recognition is a fraud risk, thus requiring the auditor to respond with appropriate audit procedures. Numerous financial frauds have been perpetrated by management through premature or fictitious revenue recognition schemes.

The recognition of fictitious revenue often results in complementary false and uncollectible receivables. Historically, one of the most widely used substantive tests for determining the existence of receivables and similar assets and, perhaps, for detecting revenue-related fraud as a result, has been direct communication by the auditor with the issuer's customers and others. That audit procedure is based on the premise that audit evidence obtained from third parties will provide the auditor with higher quality audit evidence than is typically available from within the entity.[37]

PCAOB auditing standards permit the use of either positive or negative confirmation requests.[38] With positive confirmation requests, audit evidence is obtained when the auditor receives completed confirmations from the issuer's customers or other intended recipients[39] or, in the absence of such responses, when the auditor performs alternative procedures, such as the examination of shipping documents and cash receipts.[40] (Recipients of negative confirmations are requested to respond only if they disagree with the stated information.) The interim auditing standards caution auditors to use negative confirmations only when certain conditions are present, one of which is that the combined assessed level of inherent and control risk is low.[41] When auditors do not request confirmation of accounts receivable or do not receive responses to positive confirmation requests, they should apply alternative procedures to obtain the evidence necessary to reduce audit risk to an acceptably low level.

PCAOB inspection teams have identified instances in which auditors who had not requested confirmations of account balances or had not received responses to positive confirmation requests either failed to obtain, or failed to include evidence in their audit documentation that they had obtained, sufficient other evidence regarding the existence of accounts receivable balances.

Roll-Forward of Interim Substantive Testing

Auditors usually perform some of their audit work as of an interim date. Interim audit procedures may include confirmation of accounts receivable and observation of physical inventories. PCAOB auditing standards allow auditors to apply substantive tests to the details of asset or liability accounts as of an interim date if additional substantive tests can be designed to cover the remaining period to provide a reasonable basis for extending the audit conclusions at the interim date to the balance sheet date.[42]

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[37] See paragraph .34 of AU §330, *The Confirmation Process.*

[38] See AU § 330.17.

[39] See AU § 330.18.

[40] See AU § 330.31–.32.

[41] See AU § 330.20.

[42] See paragraph .03 of AU § 313, *Substantive Tests Prior to the Balance Sheet Date*.

Interim audit work creates a somewhat higher risk that the auditor will not detect fraud because management may record fraudulent transactions in this roll-forward period, believing that the auditors will be less likely to detect them. The auditing standards caution auditors that such interim audit procedures potentially increase the risk that misstatements that exist at the balance sheet date will not be detected by the auditor. Furthermore, audit risk tends to increase as the period from the interim date to the balance-sheet date is lengthened.[43]

Therefore, in determining audit procedures to be performed from the interim date to the balance-sheet date, auditors should consider the following factors: the length of the period between the interim and balance-sheet dates; any changes in controls; the nature and volume of transactions during this period; the comparability of the items comprising the account balance at the interim and balance-sheet dates; and any misstatements detected as a result of the interim procedures.[44]

PCAOB inspection teams have observed that some auditors failed to perform, or failed to include evidence in their audit documentation that they had performed, adequate substantive roll-forward procedures to cover the activity from the interim date to the balance sheet date.

Review of Interim Financial Information

Financial frauds, including revenue and expense recognition schemes, often originate with the manipulation of quarterly earnings. The SEC requires the auditor to review the issuer's interim financial information before the company files its quarterly report on Form 10-Q or Form 10-QSB with the SEC for each of the first three quarters of the company's fiscal year. In addition, certain issuers, pursuant to item 302(a) of Regulation S-K, are required to include selected quarterly financial data in their annual (and certain other) filings with the SEC. Thus, a review of a company's interim financial information is required for the fourth quarter for those issuers, even though the company does not file a report on Form 10-Q or Form 10-QSB for that quarter. PCAOB inspection teams observed, in some instances, that auditors had failed to perform, or failed to include evidence in their audit documentation that they had performed, sufficient procedures with respect to the review of fourth-quarter financial information for those issuers that were required to disclose selected quarterly financial data.

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The particular inspection observations described in this report gave rise to quality control concerns that were communicated to the firms at which the deficiencies were identified. By law, those quality control criticisms are not made public with respect to any particular firm if the firm addresses the criticism to the Board's satisfaction within 12 months after the issuance of the inspection report on the firm.[45] No later than the conclusion of this 12-month period, a firm that seeks to keep such criticisms nonpublic must provide the Board with explanation and evidence, which the Board evaluates, concerning how the firm

[43] Ibid.

[44] See AU § 313.04–.07.

[45] See Section 104(g)(2) of the Sarbanes-Oxley Act of 2002.

has addressed the criticisms.[46] To date, the Board's initial experience with the remediation process has been very positive;[47] the Board will continue to monitor the firms' progress in this important area.

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[46] See generally, PCAOB Release 104-2006-077 (March 21, 2006), *The Process for Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms In Inspection Reports*.

[47] See PCAOB Release 104-2006-078 (March 21, 2006), *Observations on the Initial Implementation of the Process for Addressing Quality Control Criticisms Within 12 Months After An Inspection Report*.

PCAOB Release No. 2007-005A

Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements, *and Related Independence Rule and Conforming Amendments*

PCAOB Release No. 2007-005A
June 12, 2007

PCAOB Rulemaking
Docket Matter No. 021

Summary

After public comment, the Public Company Accounting Oversight Board is adopting Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, as well as an independence rule and conforming amendments to the Board's auditing standards.

Board Contact

Sharon Virag, Associate Chief Auditor (202/207-9164)

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1. Introduction

In 2002, Congress passed the Sarbanes-Oxley Act (the "Act"), which, among other things, established new provisions related to internal control over financial reporting. Section 404 of the Act requires company management to assess and report on the effectiveness of the company's internal control. It also requires a company's independent auditor, registered with the Public Company Accounting Oversight Board ("PCAOB" or "Board"), to attest to management's disclosures regarding the effectiveness of its internal control. As directed by Sections 103 and 404 of the Act, the Board established a standard to govern the newly required audit by adopting Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("Auditing Standard No. 2").[1] The Securities and Exchange Commission ("Commission" or "SEC") approved Auditing Standard No. 2 on June 17, 2004.[2]

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[1] See PCAOB Release No. 2004-001 (March 9, 2004).

[2] See Securities Exchange Act Release No. 49884 (June 17, 2004).

Since Auditing Standard No. 2 became effective, the Board has closely monitored the progress registered firms have made in implementing its requirements. The PCAOB's monitoring has included gathering information during inspections of registered public accounting firms; participating, along with the SEC, in two roundtable discussions with representatives of issuers, auditors, investor groups, and others; meeting with its Standing Advisory Group; receiving feedback from participants in the Board's Forums on Auditing in the Small Business Environment; and reviewing academic, government, and other reports and studies.

As a result of this monitoring, two basic propositions emerged.[3] First, the audit of internal control over financial reporting has produced significant benefits, including an enhanced focus on corporate governance and controls and higher quality financial reporting. Second, these benefits have come at a significant cost. Costs have been greater than expected and, at times, the related effort has appeared greater than necessary to conduct an effective audit of internal control over financial reporting.

As part of a four-point plan to improve implementation of the internal control requirements, the Board determined to amend Auditing Standard No. 2.[4] On December 19, 2006, the Board proposed for comment a new standard on auditing internal control, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that would replace Auditing Standard No. 2. The Board also proposed a related auditing standard, *Considering and Using the Work of Others in an Audit*, an independence rule relating to the auditor's provision of internal control-related non-audit services, and conforming amendments to its auditing standards.[5]

The Board issued these proposals with the primary objectives of focusing auditors on the most important matters in the audit of internal control over financial reporting and eliminating procedures that the Board believes are unnecessary to an effective audit of internal control. The proposals were designed to both increase the likelihood that material weaknesses in companies' internal control will be found before they cause material misstatement of the financial statements and steer the auditor away from procedures that are not necessary to achieve the intended benefits. The Board also sought to make the internal control audit more clearly scalable for smaller and less complex public companies and to make the text of the standard easier to understand. In formulating these proposals, the Board re-evaluated every significant aspect of Auditing Standard No. 2.

The Board received 175 comment letters on its proposals. The Board also discussed the proposals with its Standing Advisory Group on February 22, 2007.[6] A large majority of commenters were generally supportive of the Board's proposals, particularly the top-down, risk-based approach and focus on the most

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[3] See Proposed Auditing Standard: *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Other Proposals*, PCAOB Release No. 2006-007 (Dec. 19, 2006).

[4] See PCAOB Press Release, "Board Announces Four-Point Plan to Improve Implementation of Internal Control Reporting Requirements" (May 17, 2006). The other aspects of the plan are: (1) reinforcing auditor efficiency through PCAOB inspections; (2) developing or facilitating development of implementation guidance for auditors of smaller public companies; and (3) continuing PCAOB Forums on Auditing in the Small Business Environment.

[5] Proposed Auditing Standard: *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Other Proposals*, PCAOB Release No. 2006-007 (Dec. 19, 2006).

[6] A transcript of the portion of the meeting that related to the proposals and an archived web cast of the entire meeting are available on the Board's Web site at http://pcaobus.org/News/Events/Documents/02222007_SAGMeeting/SAG_Transcript.pdf.

important matters. Based on the comments received, the Board believes that the proposal achieves, in large part, the objectives the Board set out when deciding to amend Auditing Standard No. 2. Many commenters also offered suggestions to improve the final standard, which the Board has carefully analyzed.

In considering the comments received and formulating a final standard, the Board closely coordinated its work with the SEC, which proposed guidance for management on evaluating internal control at the same time that the Board issued its proposals.[7] In addition to its role in implementing Section 404(a) of the Act, the SEC must approve new PCAOB auditing standards before they can become effective.[8] On April 4, 2007, the Commission held a public meeting to discuss the Board's proposals and the coordination of those proposals with the Commission's proposed management guidance. At the meeting, the SEC staff provided the Commission its analysis of the public comments on the PCAOB's proposal and the proposed management guidance. The Commission endorsed the recommendations of its staff and directed its staff to focus its remaining work in four areas:

- "Aligning the PCAOB's new auditing standard ... with the SEC's proposed new management guidance under Section 404, particularly with regard to prescriptive requirements, definitions, and terms";
- "Scaling the 404 audit to account for the particular facts and circumstances of companies, particularly smaller companies";
- "Encouraging auditors to use professional judgment in the 404 process, particularly in using risk-assessment"; and
- "Following a principles-based approach to determining when and to what extent the auditor can use the work of others."[9]

After careful consideration of the comments it received and the input from the SEC, the Board has refined its proposals to provide additional clarity and further help auditors to focus on the most important matters. The Board has decided to adopt the revised standard on auditing internal control as 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"), to supersede Auditing Standard No. 2. The Board has also decided to adopt the independence rule and conforming amendments to the auditing standards.[10]

2. Notable Areas of Change in the Final Standard

As stated above, the Board believes that the changes made to the proposal reflect refinements, rather than significant shifts in approach. This section describes the areas of change to the proposals that are most notable. Appendix 4 contains additional discussion of comments received on the proposals and the Board's response.

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[7] See Securities Exchange Act Release No. 54976 (Dec. 20, 2006).

[8] See Section 107 of the Act.

[9] See SEC Press Release, "SEC Commissioners Endorse Improved Sarbanes-Oxley Implementation To Ease Smaller Company Burdens, Focusing Effort On 'What Truly Matters'" (Apr. 4, 2007).

[10] As discussed below, the Board has determined not to adopt the proposed auditing standard on considering and using the work of others.

A. Alignment with management guidance

On December 20, 2006, the SEC issued proposed guidance to help management evaluate internal control for purposes of its annual assessment. In formulating a new standard on auditing internal control, the Board sought to describe an audit process that would be coordinated with management's evaluation process. Many commenters suggested, however, that the SEC's management guidance and the Board's standard should be more closely aligned.

After considering the comments in this area, the Board has decided to make changes that will improve the coordination between the SEC's management guidance and the Board's standard. In doing so, the Board has been mindful of the inherent differences in the roles of management and the auditor. Management's daily involvement with its internal control system provides it with knowledge and information that may influence its judgments about how best to evaluate internal control and the sufficiency of the evidence it needs for its annual assessment. Management also should be able to rely on self-assessment and, more generally, the monitoring component of internal control, provided the monitoring component is properly designed and operates effectively.

The auditor is required to provide an independent opinion on the effectiveness of the company's internal control over financial reporting. The auditor does not have the familiarity with the company's controls that management has and does not interact with or observe these controls with the same frequency as management. Therefore, the auditor cannot obtain sufficient evidence to support an opinion on the effectiveness of internal control based solely on observation of or interaction with the company's controls. Rather, the auditor needs to perform procedures such as inquiry, observation, and inspection of documents, or walkthroughs, which consist of a combination of those procedures, in order to fully understand and identify the likely sources of potential misstatements, while management might be aware of those risk areas on an on-going basis.

The Board believes, however, that the general concepts necessary to an understanding of internal control should be described in the same way in the Board's standard and in the SEC's guidance. Accordingly, the Board has decided to use the same definition of material weakness in its standard that the SEC uses in its final management guidance and related rules. In addition, the Board is adopting the definition of significant deficiencies that the SEC has proposed. The final standard and final management guidance also describe the same indicators of a material weakness. In addition, as described more fully below, the final standard on auditing internal control uses the term "entity-level controls" instead of "company-level controls," which was used in the proposed standard, in order to use the same term as the SEC uses in its final management guidance.[11] Auditing Standard No. 5's discussion of the effect of these controls is also consistent with the discussion of the same topic in the SEC's final guidance.

B. The top-down approach

The proposed standard on auditing internal control was structured around the top-down approach to identifying the most important controls to test. This approach follows the same principles that apply to the financial statement audit – the auditor determines the areas of focus through the identification of significant accounts and disclosures and relevant assertions. Under the proposed

[11] These terms were used interchangeably in the proposed standard and SEC's proposed management guidance and, for these purposes, they mean the same thing. See Securities Exchange Act Release No. 54976 (Dec. 20, 2006), at 12 fn. 29.

standard, the auditor would specifically identify major classes of transactions and significant processes before identifying the controls to test.

In response to comments about the level of detail in the requirements of the proposed standard, the Board has reconsidered whether the final standard should include the identification of major classes of transactions and significant processes as a specifically required step in the top-down approach. As a practical matter, the auditor will generally need to understand the company's processes to appropriately identify the correct controls to test. The Board believes, however, that specific requirements directing the auditor how to obtain that understanding are unnecessary and could contribute to a "checklist approach" to compliance, particularly for auditors who have a long-standing familiarity with the company. Accordingly, the Board has removed the requirements to identify major classes of transactions and significant processes from the final standard. While this should allow auditors to apply more professional judgment as they work through the top-down approach, the end point is the same as in the proposed standard—the requirement to test those controls that address the assessed risk of misstatement to each relevant assertion.[12]

C. Emphasis on fraud controls

The proposed standard on auditing internal control discussed fraud controls and the auditor's procedures related to these controls among the testing concepts included near the end of the standard. Commenters suggested that the placement of the discussion, or the lack of specificity regarding the controls that should be deemed fraud controls, failed to properly emphasize these controls or provide auditors with sufficient direction on how to test fraud controls. In response, the Board has made several changes in the final standard.

First, the discussion of fraud risk and anti-fraud controls has been moved closer to the beginning of the standard to emphasize to auditors the relative importance of these matters in assessing risk throughout the top-down approach.[13] Incorporating the auditor's fraud risk assessment—required in the financial statement audit—into the auditor's planning process for the audit of internal control should promote audit quality as well as better integration. While internal control cannot provide absolute assurance that fraud will be prevented or detected, these controls should help to reduce instances of fraud, and, therefore, a concerted focus on fraud controls in the internal control audit should enhance investor protection. Second, management fraud has also been identified in the final standard as an area of higher risk; accordingly, the auditor should focus more of his or her attention on this area.[14] Finally, the standard, as adopted, provides additional guidance on the types of controls that might address fraud risk.[15]

D. Entity-level controls

The proposed standard on auditing internal control emphasized entity-level controls because of their importance both to the auditor's ability to appropriately tailor the audit through a top-down approach—specifically by identifying and testing the most important controls—and to effective internal control. Additionally, the proposed standard emphasized that these controls might,

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[12] See paragraph 21.

[13] See paragraphs 14 and 15.

[14] See paragraph 11.

[15] See paragraph 14.

depending on the circumstances, allow the auditor to reduce the testing of controls at the process level. Commenters suggested that the proposed standard did not provide enough direction on how entity-level controls can significantly reduce testing, and some suggested that controls that operate at the level of precision necessary to do so are uncommon. Many commenters suggested incorporating in the final standard the discussion of direct versus indirect entity-level controls that was included in the SEC's proposed management guidance.

The Board continues to believe that entity-level controls, depending on how they are designed and operate, can reduce the testing of other controls related to a relevant assertion. This is either because the entity-level control sufficiently addresses the risk related to the relevant assertion, or because the entity-level controls provide some assurance so that the testing of other controls related to that assertion can be reduced. In response to comments and in order to clarify these concepts, the Board included in the final standard a discussion of three broad categories of entity-level controls, which vary in nature and precision, along with an explanation of how each category might have a different effect on the performance of tests of other controls.[16]

The final standard explains that some controls, such as certain control environment controls, have an important, but indirect effect, on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.

The final standard explains that other entity-level controls may not operate at the level of precision necessary to eliminate the need for testing of other controls, but can reduce the required level of testing of other controls, sometimes substantially. This is because the auditor obtains some of the supporting evidence related to a control from an entity-level control and the remaining necessary evidence from the testing of the control at the process level. Controls that monitor the operation of other controls are the best example of these types of controls. These monitoring controls help provide assurance that the controls that address a particular risk are effective and, therefore, they can provide some evidence about the effectiveness of those lower-level controls, reducing the testing of those controls that otherwise would be necessary.

Lastly, the final standard explains that some entity-level controls might operate at a level of precision that, without the need for other controls, sufficiently addresses the risk of misstatement to a relevant assertion. If a control sufficiently addresses the risk in this manner, the auditor does not need to test other controls related to that risk.

E. Walkthroughs

The proposed standard on auditing internal control would have required auditors to perform a walkthrough of each significant process each year. This proposed requirement represented a change from Auditing Standard No. 2, which required a walkthrough of each major class of transactions within a significant process. Commenters were split on the question of whether the re-calibration from major class of transactions to significant process in the proposed standard would result in a reduction of effort. Some issuers and auditors suggested that walkthroughs are already being performed on significant processes, while other

[16] See paragraph 23. The Board believes that expertise of auditors and companies in the area of entity-level controls will continue to evolve. For example, the Committee of Sponsoring Organizations of the Treadway Commission has begun a project on the monitoring component of internal control that may provide some guidance in this area.

issuers and auditors commented that this proposed requirement would make a difference. A few commenters suggested that a walkthrough of each significant process was insufficient and would negatively affect audit quality, but many others stated that walkthroughs should not be required at all.

In evaluating these comments, the Board focused principally on the objectives it believes are achieved through a properly performed walkthrough. The Board firmly believes that those objectives should be met for the auditor to verify that he or she has a sufficient understanding of the points within the processes where misstatements could occur and to properly identify the controls to test.[17] Procedures that fulfill those objectives also play an important role in the evaluation of the effectiveness of the design of the controls. The Board believes that, in some instances, the requirement to perform a walkthrough may have overshadowed the objectives it was meant to achieve. This may have resulted in some walkthroughs being performed to meet the requirement but failing to achieve the intended purpose. The final standard, therefore, focuses specifically on achieving certain important objectives, and the performance requirement is based on fulfilling those objectives as they relate to the understanding of likely sources of misstatement and the selection of controls to test.[18] While a walkthrough will frequently be the best way of attaining these goals, the auditor's focus should be on the objectives, not on the mechanics of the walkthrough. In some cases, other procedures may be equally or more effective means of achieving them.

F. Evaluation and communication of deficiencies

The proposed standard on auditing internal control required the auditor to evaluate the severity of identified control deficiencies to determine whether they are significant deficiencies or material weaknesses. It then required the auditor to communicate, in writing, to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. The proposed standard defined "significant deficiency" as "a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected." The term "significant misstatement" was defined, in turn, to mean "a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

Commenters generally supported the proposed definition of the term "significant misstatement," though some were concerned that it was too subjective. Other commenters questioned whether the standard should include a definition of significant deficiency and a requirement to communicate significant deficiencies to the audit committee. At least one commenter suggested that the term be removed from the standard.

After considering these comments, the Board has determined to make changes to the definition of significant deficiency and related requirements.[19] The Board continues to believe that the standard should require auditors to provide

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[17] See paragraph 34, which describes these objectives.

[18] See paragraph 34.

[19] The Board also made minor changes to the definition of material weakness in order to use the same definition in the SEC's management guidance and related rule. In the final standard, material weakness is defined as "a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."

relevant information about important control deficiencies—even those less severe than a material weakness—to management and to the audit committee. The final standard, therefore, requires the auditor to consider and communicate any identified significant deficiencies to the audit committee. In order to emphasize that the auditor need not scope the audit to identify all significant deficiencies, however, the Board placed these provisions in the section of the final standard that describes communications requirements.[20]

The relatively minor changes that the Board made to the definition of significant deficiency are also intended to focus the auditor on the communication requirement and away from scoping issues. The final definition is based on the proposed definition of "significant misstatement," which commenters generally supported, and is aligned with the SEC's proposed definition of the same term. Under the final standard, a significant deficiency is "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

G. Scaling the audit

The proposed standard on auditing internal control indicated that a company's size and complexity are important considerations and that the procedures an auditor should perform depend upon where along the size and complexity continuum a company falls. The proposed standard included a section on scaling the audit for smaller, less complex companies and would have required auditors to evaluate and document the effect of the company's size and complexity on the audit. This documentation requirement applied to audits of companies of all sizes. The proposed standard also included a list of the attributes of smaller, less complex companies and a description of how the auditor might tailor his or her procedures when these attributes are present. In general, commenters were supportive of the proposed standard's general approach to scalability, but had several recommendations for change.

Some commenters suggested that scalability should not be covered as a standalone discussion applicable only to smaller companies and that other companies, regardless of size, might have areas that are less complex. The Board agrees that the direction on scaling will be most effective if it is a natural extension of the risk-based approach and applicable to all companies. Consequently, the Board shortened the separate section on "scaling the audit," and incorporated a discussion of scaling concepts, similar to what was proposed, throughout the final standard. Specifically, notes to relevant paragraphs describe how to tailor the audit to the particular circumstances of a smaller, less complex company or unit. The Board also retained the list of attributes of smaller, less complex companies and acknowledged that, even within larger companies, some business units or processes may be less complex than others. Discussion of these attributes has been incorporated in the section on the auditor's planning procedures in the final standard.[21] As described in the proposing release, the

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[20] See paragraph 80. The final standard also includes the proposed requirement for the auditor to communicate, in writing, to management, all deficiencies in internal control identified during the audit and inform the audit committee when such a communication has been made, and the proposed requirement to inform, when applicable, the board of directors of the auditor's conclusion that the audit committee's oversight is ineffective. See paragraphs 79 and 81. Some commenters believed that the requirement to communicate all identified deficiencies to management would result in an unnecessary administrative exercise. The Board continues to believe, however, that auditors should provide information about identified control deficiencies to management.

[21] See paragraph 9.

provisions on scalability in the final standard will form the basis for guidance on auditing internal control in smaller companies to be issued this year.

Several commenters, mostly auditors, suggested that the performance requirements that applied to all companies, including large, complex companies, would lead to unnecessary and costly documentation requirements. These commenters were particularly concerned about the requirement to document the effects of size and complexity on all aspects of the audit, even if a particular engagement could not be tailored as a result of these factors. After considering these comments, the Board agreed that this documentation requirement is not necessary to promote audit quality and, therefore, has not included it in the final standard.

H. Use of the work of others in an integrated audit

At the time the Board proposed Auditing Standard No. 5 for public comment, the Board also proposed an auditing standard entitled Considering and Using the Work of Others in an Audit that would have superseded the Board's interim standard AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* ("AU sec. 322"), and replaced the direction on using the work of others in an audit of internal control in Auditing Standard No. 2. As discussed in the proposing release, the Board had several objectives in proposing this standard. The first was to better integrate the financial statement audit and the audit of internal control by having only one framework for using the work of others in both audits. Additionally, the Board wanted to encourage auditors to use the work of others to a greater extent when the work is performed by sufficiently competent and objective persons. Among other things, under the proposed standard, auditors would have been able to use the work of sufficiently competent and objective company personnel—not just internal auditors—and third parties working under the direction of management or the audit committee for purposes of the financial statement audit as well as the audit of internal control.

The Board received numerous comments on the proposed standard on using the work of others. Commenters generally indicated support for a single framework regarding the auditor's use of the work of others in an integrated audit. Some, however, suggested retaining existing AU sec. 322 as the basis for that single framework. They expressed the view that the objective of removing barriers to integration and using the work of others to the fullest extent appropriate could be achieved by retaining AU sec. 322 and going forward with the proposed removal of the "principal evidence" provision. At the same time, some other commenters suggested that the proposed standard did not go far enough in encouraging auditors to use the work of others.

After considering these comments, the Board continues to believe that a single framework for the auditor's use of the work of others is preferable to separate frameworks for the audit of internal control and the audit of financial statements. The factors used to determine whether and to what extent it is appropriate to use the work of others should be the same for both audits. At the same time, the Board agreed with those commenters who suggested that better integration of the audits could be achieved without replacing the existing auditing standard. The Board therefore has decided to retain AU sec. 322 for both audits and incorporate language into Auditing Standard No. 5 that establishes these integration concepts rather than adopt the proposed standard on considering and using the work of others.

Consistent with the proposal, however, Auditing Standard No. 5 allows the auditor to use the work of others to obtain evidence about the design and operating effectiveness of controls and eliminates the principal evidence provision. Recognizing that issuers might employ personnel other than internal auditors to perform activities relevant to management's assessment of internal control over financial reporting, the final standard allows the auditor to use the work of company personnel other than internal auditors, as well as third parties working under the direction of management or the audit committee.[22]

In line with the overall risk-based approach to the audit of internal control over financial reporting, the extent to which the auditor may use the work of others depends, in part, on the risk associated with the control being tested. As the risk decreases, so does the need for the auditor to perform the work him or herself. The impact of the work of others on the auditor's work also depends on the relationship between the risk and the competence and objectivity of those who performed the work. As the risk decreases, the necessary level of competence and objectivity decreases as well.[23] Likewise, in higher risk areas (for example, controls that address specific fraud risks), use of the work of others would be limited, if it could be used at all.

Finally, the Board understands that some of the work performed by others for the purposes of management's assessment of internal controls can be relevant to the audit of financial statements. Therefore, in an integrated audit, the final standard allows the auditor to use the work of these sufficiently competent and objective others—not just internal auditors—to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of financial statements.[24] The Board believes that this provision will promote better integration of the audit of internal control with the audit of financial statements.

3. Rule 3525—Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting

The Board also proposed a new rule related to the auditor's responsibilities when seeking audit committee pre-approval of internal control related non-audit services. As proposed, the rule required a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal control-related non-audit services that are not otherwise prohibited by the Act or the rules of the SEC or the Board to: describe, in writing, to the audit committee the scope of the proposed service; discuss with the audit committee the potential effects of the proposed service on the firm's independence; and document the substance of the firm's discussion with the audit committee. These requirements parallel the auditor's responsibility in seeking audit committee pre-approval to perform tax services for an audit client under PCAOB Rule 3524. Most commenters were supportive of the rule as proposed, though some offered suggestions about what should be included in the required communication. After considering the comments on the proposed rule, the Board has adopted it without change.

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[22] See paragraph 17.

[23] See paragraph 18.

[24] See paragraph 17.

4. Conforming Amendments

As part of the proposal issued for public comment, the Board proposed amendments to certain of the Board's other auditing standards. Only one comment letter specifically addressed the proposed amendments. That letter expressed support for the amendments and suggested a few additional amendments that might be necessary. The Board has considered this comment and added these additional amendments, as well as others, as necessary based on the final standard.

5. Effective Date

The proposing release solicited commenters' feedback on how the Board could structure the effective date of the final requirements so as to best minimize disruption to ongoing audits, but make greater flexibility available to auditors as early as possible. Most commenters on this topic suggested making the final standard on auditing internal control effective as soon as possible in order to be available for 2007 audits.

The Board agrees that the improvements in Auditing Standard No. 5 should be available as soon as possible. Accordingly, the Board has determined that Auditing Standard No. 5, Rule 3525, and the conforming amendments will be effective, subject to approval by the SEC, for audits of fiscal years ending on or after November 15, 2007. Earlier adoption is permitted, however, at any point after SEC approval. Auditors who elect to comply with Auditing Standard No. 5 after SEC approval but before its effective date must also comply, at the same time, with Rule 3525 and other PCAOB standards as amended by this release.

Auditing Standard No. 2 will be superseded when Auditing Standard No. 5 becomes effective. Auditors who do not elect to comply with Auditing Standard No. 5 before that date (but after SEC approval) must continue to comply with Auditing Standard No. 2 until it is superseded. Such auditors should, however, apply the definition of "material weakness" contained in Auditing Standard No. 5, rather than the one contained in Auditing Standard No. 2. The SEC has adopted a rule to define the term "material weakness," and the definition in Auditing Standard No. 5 parallels the new SEC definition.

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On the 24th day of May, in the year 2007, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Secretary
June 12, 2007

APPENDICES—

1. Auditing Standard No. 5—An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements
2. Rule 3525—Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting
3. Conforming Amendments to PCAOB Auditing Standards
4. Additional Discussion of Comments and the Board's Response

Appendix 1

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

Introduction

1. This standard establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of **management's assessment**[1] of the effectiveness **of internal control over financial reporting** ("the audit of internal control over financial reporting") that is integrated with an audit of the financial statements.[2]

2. Effective internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes.[3] If one or more **material weaknesse**s exist, the company's internal control over financial reporting cannot be considered effective.[4]

3. The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company's internal control over financial reporting. Because a company's internal control cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance[5] about whether material weaknesses exist as of the date specified in management's assessment. A material weakness in internal control over financial reporting may exist even when financial statements are not materially misstated.

4. The general standards[6] are applicable to an audit of internal control over financial reporting. Those standards require technical training and proficiency as an auditor, independence, and the exercise of due professional care, including professional skepticism. This standard establishes the fieldwork and reporting standards applicable to an audit of internal control over financial reporting.

5. 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.[7]

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

[2] This auditing standard supersedes Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*, and is the standard on attestation engagements referred to in Section 404(b) of the Act. It also is the standard referred to in Section 103(a)(2)(A)(iii) of the Act.

[3] See Securities Exchange Act Rules 13a-15(f) and 15d-15(f), 17 C.F.R. §§ 240.13a-15(f) and 240.15d-15(f); Paragraph A5.

[4] See Item 308 of Regulation S-K, 17 C.F.R. § 229.308.

[5] See AU section 230, *Due Professional Care in the Performance of Work*, for further discussion of the concept of reasonable assurance in an audit.

[6] See AU section 150, *Generally Accepted Auditing Standards*.

[7] See Securities Exchange Act Rules 13a-15(c) and 15d-15(c), 17 C.F.R. §§ 240.13a-15(c) and 240.15d-15(c). SEC rules require management to base its evaluation of the effectiveness of the

(continued)

Integrating the Audits

6. The audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits.

7. In an integrated audit of internal control over financial reporting and the financial statements, the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously—

- To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end, and
- To obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.

8. Obtaining sufficient evidence to support control risk assessments of low for purposes of the financial statement audit ordinarily allows the auditor to reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements. (See Appendix B for additional direction on integration.)

> Note: In some circumstances, particularly in some audits of smaller and less complex companies, the auditor might choose not to assess control risk as low for purposes of the audit of the financial statements. In such circumstances, the auditor's tests of the operating effectiveness of controls would be performed principally for the purpose of supporting his or her opinion on whether the company's internal control over financial reporting is effective as of year-end. The results of the auditor's financial statement auditing procedures also should inform his or her risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Planning the Audit

9. The auditor should properly plan the audit of internal control over financial reporting and properly supervise any assistants. When planning an integrated audit, 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;

(footnote continued)

company's internal control over financial reporting on a suitable, recognized control framework (also known as control criteria) established by a body or group that followed due-process procedures, including the broad distribution of the framework for public comment. For example, the report of the Committee of Sponsoring Organizations of the Treadway Commission (known as the COSO report) provides such a framework, as does the report published by the Financial Reporting Council, Internal Control Revised Guidance for Directors on the Combined Code, October 2005 (known as the Turnbull Report).

- 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, risk, and other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee[8] 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.

Role of Risk Assessment

10. Risk assessment underlies the entire audit process described by this standard, including the determination of **significant accounts and disclosures** and **relevant assertion**s, the selection of controls to test, and the determination of the evidence necessary for a given control.

11. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention that should be devoted to that area. In addition, the risk that a company's internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error. The auditor should focus more of his or her attention on the areas of highest risk. On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

12. The complexity of the organization, business unit, or process, will play an important role in the auditor's risk assessment and the determination of the necessary procedures.

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[8] 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).

Scaling the Audit

13. 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 objective**s. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks. Scaling is most effective as a natural extension of the risk-based approach and applicable to the audits of all companies. Accordingly, a smaller, less complex company, or even a larger, less complex company might achieve its control objectives differently than a more complex company. [9]

Addressing the Risk of Fraud

14. When planning and performing the audit of internal control over financial reporting, the auditor should take into account the results of his or her fraud risk assessment.[10] As part of identifying and testing entity-level controls, as discussed beginning at paragraph 22, and selecting other controls to test, as discussed beginning at paragraph 39, the auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls. Controls that might address these risks include—

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

15. If the auditor identifies deficiencies in controls designed to prevent or detect fraud during the audit of internal control over financial reporting, the auditor should take into account those deficiencies when developing his or her response to risks of material misstatement during the financial statement audit, as provided in AU section 316.44 and .45.

Using the Work of Others

16. The auditor should evaluate the extent to which he or she will use the work of others to reduce the work the auditor might otherwise perform himself or herself. AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, applies in an integrated audit of the financial statements and internal control over financial reporting.

17. For purposes of the audit of internal control, however, the auditor may use the work performed by, or receive direct assistance from, internal auditors,

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[9] The SEC Advisory Committee on Smaller Public Companies considered a company's size with respect to compliance with the internal control reporting provisions of the Act. See Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission, Final Report, at p. 5 (April 23, 2006).

[10] See paragraphs .19–.42 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, regarding identifying risks that may result in material misstatement due to fraud.

company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides evidence about the effectiveness of internal control over financial reporting. In an integrated audit of internal control over financial reporting and the financial statements, the auditor also may use this work to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of the financial statements.

18. The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work. The auditor should apply paragraphs .09–.11 of AU section 322 to assess the competence and objectivity of internal auditors. The auditor should apply the principles underlying those paragraphs to assess the competence and objectivity of persons other than internal auditors whose work the auditor plans to use.

Note: For purposes of using the work of others, competence means the attainment and maintenance of a level of understanding and knowledge that enables that person to perform ably the tasks assigned to them, and objectivity means the ability to perform those tasks impartially and with intellectual honesty. To assess competence, the auditor should evaluate factors about the person's qualifications and ability to perform the work the auditor plans to use. To assess objectivity, the auditor should evaluate whether factors are present that either inhibit or promote a person's ability to perform with the necessary degree of objectivity the work the auditor plans to use.

Note: The auditor should not use the work of persons who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of persons who have a low level of competence regardless of their degree of objectivity. Personnel whose core function is to serve as a testing or compliance authority at the company, such as internal auditors, normally are expected to have greater competence and objectivity in performing the type of work that will be useful to the auditor.

19. The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.

Materiality

20. 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.[11]

Using a Top-Down Approach

21. The auditor should use a top-down approach to the audit of internal control over financial reporting to select the controls to test. A top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal control over financial reporting. The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the

[11] See AU section 312, *Audit Risk and Materiality in Conducting an Audit*, which provides additional explanation of materiality.

auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the **financial statements and related disclosures**. The auditor then verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion.

Note: The top-down approach describes the auditor's sequential thought process in identifying risks and the controls to test, not necessarily the order in which the auditor will perform the auditing procedures.

Identifying Entity-Level Controls

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

23. Entity-level controls vary in nature and precision—

- Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.
- Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower-level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls.
- Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.

24. Entity-level controls include—

- Controls related to the control environment;
- Controls over management override;

  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.
- The company's risk assessment process;

- Centralized processing and controls, including shared service environments;
- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;
- Controls over the period-end financial reporting process; and
- Policies that address significant business control and risk management practices.

25. *Control Environment*. Because of its importance to effective internal control over financial reporting, the auditor must evaluate the control environment at the company. As part of evaluating the control environment, the auditor should assess—

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

26. *Period-end Financial Reporting Process*. Because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements, the auditor must evaluate the period-end financial reporting process. The period-end financial reporting process includes the following—

- Procedures used to enter transaction totals into the general ledger;
- Procedures related to the selection and application of accounting policies;
- 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 and quarterly financial statements; and
- Procedures for preparing annual and quarterly financial statements and related disclosures.

  Note: Because the annual period-end financial reporting process normally occurs after the "as-of" date of management's assessment, those controls usually cannot be tested until after the as-of date.

27. As part of evaluating the period-end financial reporting process, the auditor should assess—

- Inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements;
- The extent of information technology ("IT") involvement in the period-end financial reporting process;
- Who participates from management;

- The locations involved in the period-end financial reporting process;
- The types of adjusting and consolidating entries; and
- The nature and extent of the oversight of the process by management, the board of directors, and the audit committee.

Note: The auditor should obtain sufficient evidence of the effectiveness of those quarterly controls that are important to determining whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion as of the date of management's assessment. However, the auditor is not required to obtain sufficient evidence for each quarter individually.

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

28. The auditor should identify significant accounts and disclosures and their relevant assertions. Relevant assertions are those financial statement assertions that have a reasonable possibility of containing a misstatement that would cause the financial statements to be materially misstated. The financial statement assertions include[12]—

- Existence or occurrence
- Completeness
- Valuation or allocation
- Rights and obligations
- Presentation and disclosure

Note: The auditor may base his or her work on assertions that differ from those in this standard if the auditor has selected and tested controls over the pertinent risks in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated.

29. To identify significant accounts and disclosures and their relevant assertions, 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 errors or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- Nature of the account or disclosure;
- Accounting and reporting complexities associated with the account or disclosure;

[12] See AU section 326, *Evidential Matter*, which provides additional information on financial statement assertions.

- 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 or disclosure characteristics.

30. 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.

31. 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.[13]

32. The components of a potential significant account or disclosure might be subject to significantly differing risks. If so, different controls might be necessary to adequately address those risks.

33. 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. Having made those determinations, the auditor should then apply the direction in Appendix B for multiple locations scoping decisions.

Understanding Likely Sources of Misstatement

34. To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives—

- Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded;
- Verify that the auditor has identified the points within the company's processes at which a misstatement—including a misstatement due to fraud—could arise that, individually or in combination with other misstatements, would be material;
- Identify the controls that management has implemented to address these potential misstatements; and

[13] This is because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high (see AU sec. 312.39 for further discussion about undetected misstatement) or as a means of introducing unpredictability in the procedures performed (see paragraph 61 and AU sec. 316.50 for further discussion about predictability of auditing procedures).

- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.

35. Because of the degree of judgment required, the auditor should either perform the procedures that achieve the objectives in paragraph 34 himself or herself or supervise the work of others who provide direct assistance to the auditor, as described in AU section 322.

36. The auditor also should understand how IT affects the company's flow of transactions. The auditor should apply paragraphs .16–.20, .30–.32, and .77–.79, of AU section 319, *Consideration of Internal Control in a Financial Statement Audit*, which discuss the effect of information technology on internal control over financial reporting and the risks to assess.

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

37. *Performing Walkthroughs*. Performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 34. 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 information technology that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

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.

Selecting Controls to Test

39. 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.

40. There might be more than one control that addresses the assessed risk of misstatement to a particular relevant assertion; conversely, one control might address the assessed risk of misstatement to more than one relevant assertion. It is neither necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective.

41. The decision as to whether a control should be selected for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of misstatement to a given relevant assertion rather than on

how the control is labeled (e.g., entity-level control, transaction-level control, control activity, monitoring control, **preventive control**, **detective control**).

Testing Controls

Testing Design Effectiveness

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

> 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.

43. 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.

Testing Operating Effectiveness

44. The auditor should test the operating effectiveness of a control 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.

> Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.

45. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Relationship of Risk to the Evidence to be Obtained

46. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

Note: Although the auditor must obtain evidence about the effectiveness of controls for each relevant assertion, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to express an opinion on the company's internal control over financial reporting overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

47. Factors that affect the risk associated with a control include—

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) and assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of entity-level controls, especially controls that monitor other controls;
- The nature of the control and the frequency with which it operates;
- 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); and

  Note: A less complex company or business unit with simple business processes and centralized accounting operations might have relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the IT general controls that are important to the effective operation of those application controls.

- The complexity of the control and the significance of the judgments that must be made in connection with its operation.

  Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

48. When the auditor identifies deviations from the company's controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control.

Note: Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.

49. 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 may provide sufficient evidence in relation to the risk associated with the control.

Note: Walkthroughs usually consist of a combination of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control and might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough and the results of those procedures.

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

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

51. The nature of the tests of effectiveness that will provide competent 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.

52. *Timing of Tests of Controls.* Testing controls over a greater period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Further, testing performed closer to the date of management's assessment provides more evidence than testing performed earlier in the year. The auditor should balance performing the tests of controls closer to the as-of date with the need to test controls over a sufficient period of time to obtain sufficient evidence of operating effectiveness.

53. Prior to the date specified in management's assessment, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. If the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, he or she will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment, the auditor should test the design and operating effectiveness of those superseded controls, as appropriate. (See additional direction on integration beginning at paragraph B1.)

54. *Extent of Tests of Controls.* The more extensively a control is tested, the greater the evidence obtained from that test.

55. *Roll-Forward Procedures.* When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.

56. The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors—

- The specific control tested prior to the as-of date, including the risks associated with the control and the nature of the control, and the results of those tests;
- The sufficiency of the evidence of effectiveness obtained at an interim date;
- The length of the remaining period; and
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

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

Special Considerations for Subsequent Years' Audits

57. In subsequent years' audits, the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal control over financial reporting into the decision-making process for determining the nature, timing, and extent of testing necessary. This decision-making process is described in paragraphs 46–56.

58. Factors that affect the risk associated with a control in subsequent years' audits include those in paragraph 47 and the following—

- The nature, timing, and extent of procedures performed in previous audits,
- The results of the previous years' testing of the control, and
- Whether there have been changes in the control or the process in which it operates since the previous audit.

59. After taking into account the risk factors identified in paragraphs 47 and 58, the additional information available in subsequent years' audits might permit the auditor to assess the risk as lower than in the initial year. This, in turn, might permit the auditor to reduce testing in subsequent years.

60. The auditor may also use a benchmarking strategy for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B28.

61. In addition, the auditor should vary the nature, timing, and extent of testing of controls from year to year to introduce unpredictability into the testing and respond to changes in circumstances. For this reason, each year the auditor might test controls at a different interim period, increase or reduce the

number and types of tests performed, or change the combination of procedures used.

Evaluating Identified Deficiencies

62. The auditor must evaluate the severity of each control **deficiency** that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses as of the date of management's assessment. In planning and performing the audit, however, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.

63. The severity of a deficiency depends on—

- Whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure; and
- The magnitude of the potential misstatement resulting from the deficiency or deficiencies.

64. The severity of a deficiency does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement.

65. Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following—

- The nature of the financial statement accounts, disclosures, and assertions involved;
- The susceptibility of the related asset or liability to loss or fraud;
- The subjectivity, complexity, or extent of judgment required to determine the amount involved;
- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant;
- The interaction of the deficiencies; and
- The possible future consequences of the deficiency.

  Note: The evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.

  Note: Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a material weakness, even though such deficiencies may individually be less severe. Therefore, the auditor should determine whether individual control deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a material weakness.

66. Factors that affect the magnitude of the misstatement that might result from a deficiency or deficiencies in controls include, but are not limited to, the following—

- The financial statement amounts or total of transactions exposed to the deficiency; and
- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

67. In evaluating the magnitude of the potential misstatement, the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

68. The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.

Indicators of Material Weaknesses

69. Indicators of material weaknesses in internal control over financial reporting include—

- Identification of fraud, whether or not material, on the part of senior management;[14]
- Restatement of previously issued financial statements to reflect the correction of a material misstatement;[15]
- Identification by the auditor of a material misstatement of financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal control over financial reporting; and
- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

70. When evaluating the severity of a deficiency, or combination of deficiencies, the auditor also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. If the auditor determines that a deficiency, or combination of deficiencies, might prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles, then the auditor should treat the deficiency, or combination of deficiencies, as an indicator of a material weakness.

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[14] For the purpose of this indicator, the term "senior management" includes the principal executive and financial officers signing the company's certifications as required under Section 302 of the Act as well as any other members of senior management who play a significant role in the company's financial reporting process.

[15] See Financial Accounting Standards Board Statement No. 154, *Accounting Changes and Error Corrections*, regarding the correction of a misstatement.

Wrapping-Up

Forming an Opinion

71. 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.

Note: As part of this evaluation, the auditor should review reports issued during the year by internal audit (or similar functions) that address controls related to internal control over financial reporting and evaluate control deficiencies identified in those reports.

72. After forming an opinion on the effectiveness of the company's internal control over financial reporting, the auditor should evaluate the presentation of the elements that management is required, under the SEC's rules, to present in its annual report on internal control over financial reporting.[16]

73. If the auditor determines that any required elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should follow the direction in paragraph C2.

74. The auditor may form an opinion on the effectiveness of internal control over financial reporting only when there have been no restrictions on the scope of the auditor's work. A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement (see paragraphs C3–C7).

Obtaining Written Representations

75. In an audit of internal control over financial reporting, the auditor should obtain written representations from management—

a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;

b. Stating that management has performed an evaluation and made an assessment of the effectiveness of the company's internal control over financial reporting and specifying the control criteria;

c. Stating that management did not use the auditor's procedures performed during the audits of internal control over financial reporting or the financial statements as part of the basis for management's assessment of the effectiveness of internal control over financial reporting;

d. Stating management's conclusion, as set forth in its assessment, about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date;

e. Stating that management has disclosed to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's evaluation, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control over financial reporting;

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[16] See Item 308(a) of Regulations S-B and S-K, 17 C.F.R. §§ 228.308(a) and 229.308(a).

f. Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a material misstatement to the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting;

g. Stating whether control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraphs 78 and 80 have been resolved, and specifically identifying any that have not; and

h. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

76. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit. As discussed further in paragraph C3, when the scope of the audit is limited, the auditor should either withdraw from the engagement or disclaim an opinion. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, including those obtained in the audit of the company's financial statements.

77. AU section 333, *Management Representations*, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updated letter.

Communicating Certain Matters

78. The auditor must communicate, in writing, to management and the audit committee all material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on internal control over financial reporting.

79. If the auditor concludes that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that conclusion in writing to the board of directors.

80. The auditor also should consider whether there are any deficiencies, or combinations of deficiencies, that have been identified during the audit that are **significant deficiencies** and must communicate such deficiencies, in writing, to the audit committee.

81. The auditor also should communicate to management, in writing, all deficiencies in internal control over financial reporting (i.e., those deficiencies in internal control over financial reporting that are of a lesser magnitude than material weaknesses) identified during the audit and inform the audit committee when such a communication has been made. When making this communication, it is not necessary for the auditor to repeat information about such deficiencies that has been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organization.

82. The auditor is not required to perform procedures that are sufficient to identify all control deficiencies; rather, the auditor communicates deficiencies in internal control over financial reporting of which he or she is aware.

83. Because the audit of internal control over financial reporting does not provide the auditor with assurance that he or she has identified all deficiencies less severe than a material weakness, the auditor should not issue a report stating that no such deficiencies were noted during the audit.

84. When auditing internal control over financial reporting, the auditor may become aware of fraud or possible illegal acts. In such circumstances, the auditor must determine his or her responsibilities under AU section 316, *Consideration of Fraud in a Financial Statement Audit*, AU section 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[17]

Reporting on Internal Control

85. The auditor's report on the audit of internal control over financial reporting must include the following elements[18]—

a. A title that includes the word *independent*;

b. A statement that management is responsible for maintaining effective internal control over financial reporting and for assessing the effectiveness of internal control over financial reporting;

c. An identification of management's report on internal control;

d. A statement that the auditor's responsibility is to express an opinion on the company's internal control over financial reporting based on his or her audit;

e. A definition of internal control over financial reporting as stated in paragraph A5;

f. A statement that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);

g. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;

h. A statement that an audit includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances;

i. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion;

j. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may

[17] See 15 U.S.C. § 78j-1.

[18] See Appendix C, which provides direction on modifications to the auditor's report that are required in certain circumstances.

become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate;

k. The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria;

l. The manual or printed signature of the auditor's firm;

m. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

n. The date of the audit report.

Separate or Combined Reports

86. The auditor may choose to issue a combined report (i.e., one report containing both an opinion on the financial statements and an opinion on internal control over financial reporting) or separate reports on the company's financial statements and on internal control over financial reporting.

87. The following example combined report expressing an unqualified opinion on financial statements and an unqualified opinion on internal control over financial reporting illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm [*Introductory paragraph*]

> We have audited the accompanying balance sheets of W Company as of December 31, 20X8 and 20X7, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8. We also have audited W Company's internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).*"]. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits.

[*Scope paragraph*]

> We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in

the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).*"].

[*Signature*]

[*City and State or Country*]

[*Date*]

88. If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph to the auditor's report on the financial statements—

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), W Company's internal control over financial reporting as of December 31, 20X8, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinion*].

The auditor also should add the following paragraph to the report on internal control over financial reporting—

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*]

of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

Report Date

89. The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. Because the auditor cannot audit internal control over financial reporting without also auditing the financial statements, the reports should be dated the same.

Material Weaknesses

90. Paragraphs 62–70 describe the evaluation of deficiencies. If there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor must express an adverse opinion on the company's internal control over financial reporting, unless there is a restriction on the scope of the engagement.[19]

91. When expressing an adverse opinion on internal control over financial reporting because of a material weakness, the auditor's report must include—

- The definition of a material weakness, as provided in paragraph A7.
- A statement that a material weakness has been identified and an identification of the material weakness described in management's assessment.

  Note: If the material weakness has not been included in management's assessment, the report should be modified to state that a material weakness has been identified but not included in management's assessment. Additionally, the auditor's report should include a description of the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. In this case, the auditor also should communicate in writing to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's assessment. If the material weakness has been included in management's assessment but the auditor concludes that the disclosure of the material weakness is not fairly presented in all material respects, the auditor's report should describe this conclusion as well as the information necessary to fairly describe the material weakness.

92. The auditor should determine the effect his or her adverse opinion on internal control has on his or her opinion on the financial statements. Additionally, the auditor should disclose whether his or her opinion on the financial statements was affected by the adverse opinion on internal control over financial reporting.

Note: If the auditor issues a separate report on internal control over financial reporting in this circumstance, the disclosure required by this paragraph may

[19] See paragraph C3 for direction when the scope of the engagement has been limited.

be combined with the report language described in paragraphs 88 and 91. The auditor may present the combined language either as a separate paragraph or as part of the paragraph that identifies the material weakness.

Subsequent Events

93. Changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting might occur subsequent to the date as of which internal control over financial reporting is being audited but before the date of the auditor's report. The auditor should inquire of management whether there were any such changes or factors and obtain written representations from management relating to such matters, as described in paragraph 75*h*.

94. To obtain additional information about whether changes have occurred that might affect the effectiveness of the company's internal control over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following—

- Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period,
- Independent auditor reports (if other than the auditor's) of deficiencies in internal control,
- Regulatory agency reports on the company's internal control over financial reporting, and
- Information about the effectiveness of the company's internal control over financial reporting obtained through other engagements.

95. The auditor might inquire about and examine other documents for the subsequent period. Paragraphs .01–.09 of AU section 560, *Subsequent Events*, provide direction on subsequent events for a financial statement audit that also may be helpful to the auditor performing an audit of internal control over financial reporting.

96. If the auditor obtains knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal control over financial reporting as of the date specified in the assessment, the auditor should issue an adverse opinion on internal control over financial reporting (and follow the direction in paragraph C2 if management's assessment states that internal control over financial reporting is effective). If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the company's internal control over financial reporting, the auditor should disclaim an opinion. As described in paragraph C13, the auditor should disclaim an opinion on management's disclosures about corrective actions taken by the company after the date of management's assessment, if any.

97. The auditor may obtain knowledge about subsequent events with respect to conditions that did not exist at the date specified in the assessment but arose subsequent to that date and before issuance of the auditor's report. If a subsequent event of this type has a material effect on the company's internal control over financial reporting, the auditor should include in his or her report an explanatory paragraph describing the event and its effects or directing the reader's attention to the event and its effects as disclosed in management's report.

98. After the issuance of the report on internal control over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had he or she been aware of them. The auditor's evaluation of such subsequent information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

Appendix A

Definitions

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

A2. A **control objective** provides a specific target against which to evaluate the effectiveness of controls. A control objective for internal control over financial reporting generally relates to a relevant assertion and states a criterion for evaluating whether the company's control procedures in a specific area provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented or detected by controls on a timely basis.

A3. A **deficiency** in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in *design* exists when (*a*) a control necessary to meet the control objective is missing or (*b*) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.
- A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

A4. **Financial statements and related disclosures** refers to a company's financial statements and notes to the financial statements as presented in accordance with generally accepted accounting principles ("GAAP"). References to financial statements and related disclosures do not extend to the preparation of management's discussion and analysis or other similar financial information presented outside a company's GAAP-basis financial statements and notes.

A5. **Internal control over financial reporting** is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that—

(1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.[1]

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[1] See Securities Exchange Act Rules 13a-15(f) and 15d-15(f), 17 C.F.R. §§ 240.13a-15(f) and 240.15d-15(f).

Note: The auditor's procedures as part of either the audit of internal control over financial reporting or the audit of the financial statements are not part of a company's internal control over financial reporting.

Note: Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

A6. **Management's assessment** is the assessment described in Item 308(a)(3) of Regulations S-B and S-K that is included in management's annual report on internal control over financial reporting.[2]

A7. A **material weakness** is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a **reasonable possibility** that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Note: 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 Financial Accounting Standards Board Statement No. 5, Accounting for Contingencies ("FAS 5").[3]

A8. Controls over financial reporting may be **preventive controls** or **detective controls**. Effective internal control over financial reporting often includes a combination of preventive and detective controls.

- Preventive controls have the objective of preventing errors or fraud that could result in a misstatement of the financial statements from occurring.
- Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements.

A9. 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.

A10. 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.

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[2] See 17 C.F.R. §§ 228.308(a)(3) and 229.308(a)(3).

[3] See FAS 5, paragraph 3.

A11. A **significant deficiency** is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

Appendix B

Special Topics

Integration of Audits

B1. *Tests of Controls in an Audit of Internal Control.* The objective of the tests of controls in an audit of internal control over financial reporting 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*.

B2. To express an opinion on internal control over financial reporting as of a point in time, the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To express an opinion on internal control over financial reporting taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant assertions. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

B3. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on internal control over financial reporting, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements, as discussed in the following section.

B4. *Tests of Controls in an Audit of Financial Statements.* To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* upon which the auditor plans to place reliance on those controls. 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.

B5. When concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the company's internal control over financial reporting, as discussed in paragraph B2. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.

B6. *Effect of Tests of Controls on Substantive Procedures.* If, during the audit of internal control over financial reporting, the auditor identifies a deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.

B7. Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions.

Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.

B8. *Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls*. In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, at a minimum—

- The auditor's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.
- Findings with respect to illegal acts and related party transactions.
- Indications of management bias in making accounting estimates and in selecting accounting principles.
- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

B9. To obtain evidence about whether a selected 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. The absence of misstatements detected by substantive procedures, however, should inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Multiple Locations Scoping Decisions

B10. In determining the locations or business units at which to perform tests of controls, the auditor should assess the risk of material misstatement to the 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.

> Note: The auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the company's consolidated financial statements.

B11. In assessing and responding to risk, the auditor should test controls over specific risks that present a reasonable possibility of material misstatement to the company's consolidated financial statements. In lower-risk locations or business units, the auditor first might evaluate whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides the auditor with sufficient evidence.

B12. In determining the locations or business units at which to perform tests of controls, the auditor may take into account work performed by others on behalf of management. For example, if the internal auditors' planned procedures include relevant audit work at various locations, the auditor may coordinate work with the internal auditors and reduce the number of locations or business units at which the auditor would otherwise need to perform auditing procedures.

B13. The direction in paragraph 61 regarding special considerations for subsequent years' audits means that the auditor should vary the nature, timing, and extent of testing of controls at locations or business units from year to year.

B14. *Special Situations*. The scope of the audit should include entities that are acquired on or before the date of management's assessment and operations that are accounted for as discontinued operations on the date of management's assessment. The direction in this multiple-locations discussion describes how to determine whether it is necessary to test controls at these entities or operations.

B15. For equity method investments, the scope of the audit should include controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The audit ordinarily would not extend to controls at the equity method investee.

B16. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. In these situations, the auditor's opinion would not be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the scope paragraph in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities that are described in paragraphs .29–.32 of AU section 722, *Interim Financial Information*. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure requires modification.

Use of Service Organizations

B17. AU section 324, *Service Organizations*, applies to the audit of financial statements of a company that obtains services from another organization that are part of the company's information system. The auditor may apply the relevant concepts described in AU section 324 to the audit of internal control over financial reporting.

B18. AU section 324.03 describes the situation in which a service organization's services are part of a company's information system. If the service organization's services are part of a company's information system, as described therein, then they are part of the information and communication component of the company's internal control over financial reporting. When the service organization's services are part of the company's internal control over financial reporting, the auditor should include the activities of the service organization when determining the evidence required to support his or her opinion.

B19. AU section 324.07–.16 describe the procedures that the auditor should perform with respect to the activities performed by the service organization. The procedures include—

a. Obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization, and

b. Obtaining evidence that the controls that are relevant to the auditor's opinion are operating effectively.

B20. Evidence that the controls that are relevant to the auditor's opinion are operating effectively may be obtained by following the procedures described in AU section 324.12. These procedures include—

a. Obtaining a service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.

Note: The service auditor's report referred to above means a report with the service auditor's opinion on the service organization's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period (in other words, "reports on controls placed in operation and tests of operating effectiveness" described in AU section 324.24*b*). A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness (in other words, "reports on controls placed in operation" described in AU section 324.24*a*) does not provide evidence of operating effectiveness. Furthermore, if the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report issued pursuant to AU section 324, the auditor should evaluate whether the agreed-upon procedures report provides sufficient evidence in the same manner described in the following paragraph.

b. Performing tests of the user organization's controls over the activities of the service organization (e.g., testing the user organization's independent re-performance of selected items processed by the service organization or testing the user organization's reconciliation of output reports with source documents).

c. Performing tests of controls at the service organization.

B21. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, the auditor may evaluate whether this report provides sufficient evidence to support his or her opinion. In evaluating whether such a service auditor's report provides sufficient evidence, the auditor should assess the following factors—

- The time period covered by the tests of controls and its relation to the as-of date of management's assessment,
- The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the company's controls, and
- The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

Note: These factors are similar to factors the auditor would consider in determining whether the report provides sufficient evidence to support the auditor's assessed level of control risk in an audit of the financial statements, as described in AU section 324.16.

B22. If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the company applies controls contemplated in the design of the system by the service organization, the auditor should evaluate whether the company is applying the necessary procedures.

B23. In determining whether the service auditor's report provides sufficient evidence to support the auditor's opinion, the auditor should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in paragraph .10*a* of AU section 543, *Part of Audit Performed by Other Independent Auditors*.

B24. When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the company's internal control over financial reporting. The auditor also should evaluate whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization.

B25. The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following risk factors. As risk increases, the need for the auditor to obtain additional evidence increases.

- The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment,
- The significance of the activities of the service organization,
- Whether there are errors that have been identified in the service organization's processing, and
- The nature and significance of any changes in the service organization's controls identified by management or the auditor.

B26. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures might include—

- Evaluating procedures performed by management and the results of those procedures.
- Contacting the service organization, through the user organization, to obtain specific information.
- Requesting that a service auditor be engaged to perform procedures that will supply the necessary information.
- Visiting the service organization and performing such procedures.

B27. The auditor should not refer to the service auditor's report when expressing an opinion on internal control over financial reporting.

Benchmarking of Automated Controls

B28. Entirely automated application controls are generally not subject to breakdowns due to human failure. This feature allows the auditor to use a "benchmarking" strategy.

B29. If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor established a baseline (i.e., last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor should obtain to verify that the control has not changed may vary depending on the circumstances, including depending on the strength of the company's program change controls.

B30. The consistent and effective functioning of the automated application controls may be dependent upon the related files, tables, data, and parameters. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

B31. To determine whether to use a benchmarking strategy, the auditor should assess the following risk factors. As these factors indicate lower risk, the control being evaluated might be well-suited for benchmarking. As these factors indicate increased risk, the control being evaluated is less suited for benchmarking. These factors are—

- The extent to which the application control can be matched to a defined program within an application.
- The extent to which the application is stable (i.e., there are few changes from period to period).
- The availability and reliability of a report of the compilation dates of the programs placed in production. (This information may be used as evidence that controls within the program have not changed.)

B32. Benchmarking automated application controls can be especially effective for companies using purchased software when the possibility of program changes is remote—e.g., when the vendor does not allow access or modification to the source code.

B33. After a period of time, the length of which depends upon the circumstances, the baseline of the operation of an automated application control should be reestablished. To determine when to reestablish a baseline, the auditor should evaluate the following factors—

- The effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls and computer operations.
- The auditor's understanding of the nature of changes, if any, on the specific programs that contain the controls.
- The nature and timing of other related tests.

- The consequences of errors associated with the application control that was benchmarked.
- Whether the control is sensitive to other business factors that may have changed. For example, an automated control may have been designed with the assumption that only positive amounts will exist in a file. Such a control would no longer be effective if negative amounts (credits) begin to be posted to the account.

Appendix C

Special Reporting Situations

Report Modifications

C1. The auditor should modify his or her report if any of the following conditions exist.

a. Elements of management's annual report on internal control are incomplete or improperly presented,

b. There is a restriction on the scope of the engagement,

c. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report,

d. There is other information contained in management's annual report on internal control over financial reporting, or

e. Management's annual certification pursuant to Section 302 of the Sarbanes-Oxley Act is misstated.

C2. *Elements of Management's Annual Report on Internal Control Over Financial Reporting Are Incomplete or Improperly Presented*. If the auditor determines that elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should modify his or her report to include an explanatory paragraph describing the reasons for this determination. If the auditor determines that the required disclosure about a material weakness is not fairly presented in all material respects, the auditor should follow the direction in paragraph 91.

C3. *Scope Limitations*. The auditor can express an opinion on the company's internal control over financial reporting only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement, the auditor should withdraw from the engagement or disclaim an opinion. A disclaimer of opinion states that the auditor does not express an opinion on the effectiveness of internal control over financial reporting.

C4. When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the audit was not sufficient to warrant the expression of an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of internal control over financial reporting (paragraph 85 *g*, *h*, and *i*); to do so might overshadow the disclaimer.

C5. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that a material weakness exists, the auditor's report also should include—

- The definition of a material weakness, as provided in paragraph A7.
- A description of any material weaknesses identified in the company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address the requirements in paragraph 91.

C6. The auditor may issue a report disclaiming an opinion on internal control over financial reporting as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. The auditor is not required to perform any additional work prior to issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

> Note: In this case, in following the direction in paragraph 89 regarding dating the auditor's report, the report date is the date that the auditor has obtained sufficient competent evidence to support the representations in the auditor's report.

C7. If the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the audit, the auditor should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed.

C8. *Opinions Based, in Part, on the Report of Another Auditor*. When another auditor has audited the financial statements and internal control over financial reporting of one or more subsidiaries, divisions, branches, or components of the company, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinion. AU section 543, *Part of Audit Performed by Other Independent Auditors*, provides direction on the auditor's decision of whether to serve as the principal auditor of the financial statements. If the auditor decides it is appropriate to serve as the principal auditor of the financial statements, then that auditor also should be the principal auditor of the company's internal control over financial reporting. This relationship results from the requirement that an audit of the financial statements must be performed to audit internal control over financial reporting; only the principal auditor of the financial statements can be the principal auditor of internal control over financial reporting. In this circumstance, the principal auditor of the financial statements must participate sufficiently in the audit of internal control over financial reporting to provide a basis for serving as the principal auditor of internal control over financial reporting.

C9. When serving as the principal auditor of internal control over financial reporting, the auditor should decide whether to make reference in the report on internal control over financial reporting to the audit of internal control over financial reporting performed by the other auditor. In these circumstances, the auditor's decision is based on factors analogous to those of the auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements as described in AU section 543.

C10. The decision about whether to make reference to another auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment performed by another independent auditor, but the report on internal control over financial reporting might not make a similar reference because management's assessment of internal control over financial reporting ordinarily would not extend to controls at the equity method investee.[1]

C11. When the auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinion on the company's internal

[1] See paragraph B15, for further discussion of the evaluation of the controls over financial reporting for an equity method investment.

control over financial reporting, the auditor should refer to the report of the other auditor when describing the scope of the audit and when expressing the opinion.

C12. *Management's Annual Report on Internal Control Over Financial Reporting Containing Additional Information*. Management's annual report on internal control over financial reporting may contain information in addition to the elements described in paragraph 72 that are subject to the auditor's evaluation.

C13. If management's annual report on internal control over financial reporting could reasonably be viewed by users of the report as including such additional information, the auditor should disclaim an opinion on the information.

C14. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information. AU section 317, *Illegal Acts by Clients* and Section 10A of the Securities Exchange Act of 1934 may also require the auditor to take additional action.[2]

> Note: If management makes the types of disclosures described in paragraph C12 outside its annual report on internal control over financial reporting and includes them elsewhere within its annual report on the company's financial statements, the auditor would not need to disclaim an opinion. However, in that situation, the auditor's responsibilities are the same as those described in this paragraph if the auditor believes that the additional information contains a material misstatement of fact.

C15. *Management's Annual Certification Pursuant to Section 302 of the Sarbanes-Oxley Act is Misstated*. If matters come to the auditor's attention as a result of the audit of internal control over financial reporting that lead him or her to believe that modifications to the disclosures about changes in internal control over financial reporting (addressing changes in internal control over financial reporting occurring during the fourth quarter) are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[3] the auditor should follow the communication responsibilities as described in AU section 722*, Interim Financial Information*, for any interim period. However, if management and the audit committee do not respond appropriately, in addition to the responsibilities described in AU section 722, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons the auditor believes management's disclosures should be modified.

Filings Under Federal Securities Statutes

C16. AU section 711, *Filings Under Federal Securities Statutes*, describes the auditor's responsibilities when an auditor's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes. The auditor should apply AU section 711 with respect to the auditor's report on internal control over financial reporting included in such filings. In addition, the auditor should extend the direction in AU section 711.10

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[2] See 15 U.S.C. § 78j-1.

[3] See 17 C.F.R. §§ 240.13a-14(a) and 240.15d-14(a).

to inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters about whether any events have occurred that have a material effect on the audited financial statements to matters that could have a material effect on internal control over financial reporting.

C17. When the auditor has fulfilled these responsibilities and intends to consent to the inclusion of his or her report on internal control over financial reporting in the securities filing, the auditor's consent should clearly indicate that both the audit report on financial statements and the audit report on internal control over financial reporting (or both opinions if a combined report is issued) are included in his or her consent.

Appendix 2

Rule 3525. Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting

In connection with seeking audit committee pre-approval to perform for an audit client any permissible non-audit service related to internal control over financial reporting, a registered public accounting firm shall—

(a) describe, in writing, to the audit committee of the issuer the scope of the service;

(b) discuss with the audit committee of the issuer the potential effects of the service on the independence of the firm; and

Note: Independence requirements provide that an auditor is not independent of his or her audit client if the auditor is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. Several principles guide the application of this general standard, including whether the auditor assumes a management role or audits his or her own work. Therefore, an auditor would not be independent if, for example, management had delegated its responsibility for internal control over financial reporting to the auditor or if the auditor had designed or implemented the audit client's internal control over financial reporting.

(c) document the substance of its discussion with the audit committee of the issuer.

[Effective pursuant to SEC Release No. 34-56152; File No. PCAOB-2007-02; July 27, 2007]

Appendix 3

Conforming Amendments to PCAOB Auditing Standards

[Effective pursuant to SEC Release No. 34-56152; File No. PCAOB-2007-02; July 27, 2007]

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

Statement on Auditing Standards ("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. Paragraph .10 is replaced with—

> The exercise of due professional care allows the auditor to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, or whether any material weaknesses exist as of the date of management's assessment. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Although not absolute assurance, reasonable assurance is a high level of assurance. Therefore, an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) may not detect a material weakness in internal control over financial reporting or a material misstatement to the financial statements.

b. The term "financial statements" within the first sentence of paragraph .13 is replaced with the term "financial statements or internal control over financial reporting."

c. The second sentence of paragraph .13 is replaced with—

> Therefore, the subsequent discovery that either a material misstatement, whether from error or fraud, exists in the financial statements or a material weakness in internal control over financial reporting exists does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with the standards of the Public Company Accounting Oversight Board (United States).

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. The third bullet point of paragraph .06 is replaced with—

> Management is responsible for establishing and maintaining effective internal control over financial reporting. If, in an integrated audit of financial statements and

internal control over financial reporting, the auditor concludes that he or she cannot express an opinion on internal control over financial reporting because there has been a limitation on the scope of the audit, he or she should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed.

b. The eighth bullet point of paragraph .06 is amended as follows—

Under Integrated audit of financial statements and internal control over financial reporting, the last sub-bullet point is replaced with the following—

To the board of directors—any conclusion that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective.

Under Audit of financial statements, the last sub-bullet is replaced with the following—

To the board of directors—if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the audit committee is ineffective, that conclusion.

AU sec. 311, "Planning and Supervision"

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

Within the note to paragraph 1, the reference to paragraph 39 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 9 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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 amended as follows—

a. Within the note to paragraph 3, the reference to paragraphs 22–23 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 20 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. Within the note to paragraph 7, the reference to paragraphs 24–26 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 14–15 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

c. The note to paragraph 12 is replaced with—

Note: When performing an integrated audit of financial statements and internal control over financial reporting,

refer to paragraphs 9 and 20 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* regarding planning considerations and materiality, respectively.

d. Within the note to paragraph 18, the reference to Appendix B, *Additional Performance Requirements and Directions; Extent-of-Testing Examples* of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B10–B16 of Appendix B, *Special Topics,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

e. Within the note to paragraph 30, the reference to paragraphs 147–149 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 6–8 and paragraphs B1–B5 of Appendix B, *Special Topics,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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"), is amended as follows—

Within the note to paragraph 1, the reference to paragraphs 98–103 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 52–53 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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—

The last sentence of paragraph 16 is replaced with—

Furthermore, the predecessor auditor is not a specialist as defined in AU sec. 336, Using the Work of a Specialist, nor does the predecessor auditor's work constitute the work of others as described in AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, or paragraphs 16–19 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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"), is amended as follows—

Within the note to paragraph 1, the reference to paragraphs 24–26 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 14–15 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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 amended as follows—

a. The note to paragraph 2 is replaced with—

> Note: Refer to paragraph A9 of Appendix A, *Definitions,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* for the definition of a relevant assertion and paragraphs 28–33 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, for discussion of identifying relevant assertions.

b. Within the note to paragraph 9, the reference to Appendix B, *Additional Performance Requirements and Directions; Extent of Testing Examples,* of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B10–B16 of Appendix B, *Special Topics,* of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

c. The last sentence of paragraph 33 is deleted.

d. The note to paragraph 65 is deleted.

e. The note to paragraph 83 is deleted.

f. Within the note to paragraph 97, the reference to paragraphs 104–105 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 54 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

g. The appendix at paragraph 110 is deleted.

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"), is amended as follows—

a. Within the note to paragraph 1, the reference to paragraphs 108–126 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 16–19 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The note to paragraph 20 is deleted.

c. Within the note to paragraph 22, the reference to paragraph 122 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 18–19 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 324, "Service Organizations"

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

Within the note to paragraph 1, the reference to Appendix B, *Additional Performance Requirements and Directions; Extent-of-Testing Examples*, of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B17–B27 of Appendix B, *Special Topics*, of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 325, "Communications About Control Deficiencies in an Audit of Financial Statements"[1]

AU sec. 325, "Communications About Control Deficiencies in an Audit of Financial Statements" is amended as follows—

a. The first bullet point before paragraph 1 is amended as follows—

The reference to paragraphs 207–214 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 78–84 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The first bullet point in paragraph 1 is replaced with—

A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

c. Paragraph 2 is replaced with—

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting, that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

d. The notes to paragraph 2 are deleted.

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[1] When the Board adopted Auditing Standard No. 2, it superseded SAS No. 60 in the context of an integrated audit of financial statements and internal control over financial reporting by paragraphs 207-214 of Auditing Standard No. 2. See PCAOB Release No. 2004-008, *Conforming Amendments to PCAOB Interim Standards Resulting From the Adoption of PCAOB Auditing Standard No. 2*, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements" (Sept. 15, 2004). As a result of superseding Auditing Standard No. 2, paragraphs 78-84 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, now supersede SAS No. 60 in the context of an integrated audit.

e. Paragraph 3 is replaced with—

> A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.
>
> Note: There is a reasonable possibility of an event when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in paragraph 3 of Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*.
>
> Note: In evaluating whether a deficiency exists and whether deficiencies, either individually or in combination with other deficiencies, are material weaknesses, the auditor should follow the direction in paragraphs 62–70 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

f. Paragraph 5 is replaced with—

> If oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, that circumstance should be regarded as an indicator that a material weakness in internal control over financial reporting exists. Although there is not an explicit requirement to evaluate the effectiveness of the audit committee's oversight in an audit of only the financial statements, if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that information in writing to the board of directors.

g. The last sentence of paragraph 9 is replaced with—

> In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph 2 of this standard.

AU sec. 9325, "Communication of Internal Control Related Matters Noted in an Audit: Auditing Interpretations of Section 325"

AU sec. 9325, "Communication of Internal Control Related Matters Noted in an Audit: Auditing Interpretations of Section 325" is amended as follows—

> The note prior to paragraph 1 is replaced with—
>
> Note: In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph 2 of this standard. Within

the example report within paragraph 4 of the interpretation, the third sentence is replaced with the definition of a material weakness in paragraph A7 of Appendix A, *Definitions*, of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of 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"), is amended as follows—

The first sentence of paragraph 41 is replaced with—

> Events and transactions that occur after the balance-sheet date but before the date of the auditor's report (for example, a sale of an investment shortly after the balance-sheet date), may provide audit evidence regarding management's fair value measurements as of the balance-sheet date[7]

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[7] The auditor's consideration of a subsequent event or transaction, as contemplated in this paragraph, is a substantive test and thus differs from the review of subsequent events performed pursuant to section 560, *Subsequent Events*.

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

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

The note to paragraph 11 is replaced with—

> Note: When performing an integrated audit of financial statements and internal control over financial reporting, paragraph 39 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, states "[t]he 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." Therefore, in an integrated audit of financial statements and internal control over financial reporting, if there are relevant assertions related to the company's investment in derivatives and securities, the auditor's understanding of controls should include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements and should encompass controls placed in operation by the entity and service organizations whose services are part of the entity's information system.

AU sec. 333, "Management Representations"

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

a. Within the note to paragraph 5, the reference to paragraphs 142–144 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 75–77 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The second sentence of paragraph 9 is replaced with—

> Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to or disclosure in the financial statements, the representations should be made as of the date of the auditor's report.

AU sec. 9337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337"

AU sec. 9337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337" is amended as follows—

a. The last sentence of paragraph 4 is replaced with—

> What is the relationship between the effective date of the lawyer's response and the date of the auditor's report?

b. Paragraph 5 is replaced with—

> *Interpretation*—Section 560.10 through .12 indicates that the auditor is concerned with events, which may require adjustment to, or disclosure in, the financial statements, occurring through the date of his or her report. Therefore, the latest date of the period covered by the lawyer's response (the "effective date") should be as close to the date of the auditor's report as is practicable in the circumstances. Consequently, specifying the effective date of the lawyer's response to reasonably approximate the expected date of the auditor's report will in most instances obviate the need for an updated response from the lawyer.

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 a 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 second sentence of paragraph 2 is replaced with—

> The auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report.

AU sec. 342, "Auditing Accounting Estimates"

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

a. Subparagraph *c*. of paragraph 10 is replaced with—

> *c*. Review subsequent events or transactions occurring prior to the date of the auditor's report.

b. Paragraph 13 is replaced with—

> *Review subsequent events or transactions.* Events or transactions sometimes occur subsequent to the date of the balance sheet, but prior to the date of the auditor's report, that are important in identifying and evaluating the reasonableness of accounting estimates or key factors or assumptions used in the preparation of the estimate. In such circumstances, an evaluation of the estimate or of a key factor or assumption may be minimized or unnecessary as the event or transaction can be used by the auditor in evaluating their reasonableness.

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—

> Within footnote 1 to paragraph 1, the reference to PCAOB Auditing Standard No. 2 is replaced with a reference to PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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—

> Within the note to paragraph 1, the reference to paragraphs 162–199 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 85–98 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and Appendix C, *Special Reporting Situations*, of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. The sentence that reads "In addition, see Appendix A, *Illustrative Reports on Internal Control Over Financial Reporting*, of PCAOB Auditing Standard No. 2, which includes an illustrative combined audit report and examples of separate reports," is replaced with, "In addition, see paragraphs 86–88 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, which includes an illustrative combined audit report."

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. Paragraph .01 is replaced with—

> The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. Paragraph .05 describes the procedure to be followed when a subsequent event occurring after the report date is disclosed in the financial statements.
>
> Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor's reports on the company's financial statements and on internal control over financial reporting should be dated the same date.
>
> Note: If the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion on the financial statements, then the auditor's report date is the date that the auditor has obtained sufficient competent evidence to support the representations in the auditor's report.

b. Paragraph .05 is replaced with—

> The independent auditor has two methods for dating the report when a subsequent event disclosed in the financial statements occurs after the auditor has obtained sufficient competent evidence on which to base his or her opinion, but before the issuance of the related financial statements. The auditor may use "dual dating," for example, "February 16, 20_, except for Note _, as to which the date is March 1, 20_," or may date the report as of the later date. In the former instance, the responsibility for events occurring subsequent to the original report date is limited to the specific event referred to in the note (or otherwise disclosed). In the latter instance, the independent auditor's responsibility for subsequent events extends to the later report date and, accordingly, the procedures outlined in section 560.12 generally should be extended to that date.

c. Within the heading before paragraph .03, the reference to "completion of field work" is replaced with "the date of the independent auditor's report."

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—

> Within the note to paragraph .01, the reference to paragraphs 182–185 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs C8–C11 of Appendix C, *Special Reporting Situations*, of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 560, "Subsequent Events"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 560, "Subsequent Events" (AU sec. 560, "Subsequent Events"), as amended, is amended as follows—

a. Within the note to paragraph .01, the reference to paragraphs 186–189 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 93–97 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The second sentence of paragraph .12 is replaced with—

> These procedures should be performed at or near the date of the auditor's report.

AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report" (AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"), as amended, is amended as follows—

> Within the note to paragraph .01, the reference to paragraph 197 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 98 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AU sec. 711, "Filings Under Federal Securities Statutes"

SAS No. 37, "Filings Under Federal Securities Statutes" (AU sec. 711, "Filings Under Federal Securities Statutes"), is amended as follows—

a. Within the note to paragraph 2, the reference to paragraphs 198–199 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs C16–C17 of Appendix C, *Special Reporting Situations*, of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The third sentence of paragraph 10 is replaced with—

> The likelihood that the auditor will discover subsequent events necessarily decreases following the date of the auditor's report, and, as a practical matter, after that time the independent auditor may rely, for the most part, on inquiries of responsible officials and employees.

AU sec. 722, "Interim Financial Information"

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

a. The following is inserted after the first sentence of paragraph 3—

> The SEC also requires management, with the participation of the principal executive and financial officers (the certifying officers) to make certain quarterly and annual

certifications with respect to the company's internal control over financial reporting.[2]

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[2] See Section 302 of the Sarbanes-Oxley Act of 2002, and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), (17 C.F.R. §240.13a-14a or 17 C.F.R. §240.15d-14a), whichever applies.

b. The note to paragraph 3 is deleted.

c. The following is added to the end of paragraph 7—

Likewise, the auditor's responsibility as it relates to management's quarterly certifications on internal control over financial reporting is different from the auditor's responsibility as it relates to management's annual assessment of internal control over financial reporting. The auditor should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302 of the Act.

Note: The auditor's responsibilities for evaluating management's certification disclosures about internal control over financial reporting take effect beginning with the first quarter after the company's first annual assessment of internal control over financial reporting as described in Item 308(a)(3) of Regulations S-B and S-K.

d. The following lettered section is added to the end of paragraph 18—

g. Evaluating management's quarterly certifications about internal control over financial reporting by performing the following procedures—

- Inquiring of management about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information that could have occurred subsequent to the preceding annual audit or prior review of interim financial information;
- Evaluating the implications of misstatements identified by the auditor as part of the auditor's other interim review procedures as they relate to effective internal control over financial reporting; and
- Determining, through a combination of observation and inquiry, whether any change in internal control over financial reporting has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

e. Paragraph 29 is replaced with—

As a result of conducting a review of interim financial information, the accountant may become aware of matters that cause him or her to believe that—

a. Material modification should be made to the interim financial information for it to conform with generally accepted accounting principles;

b. Modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies; and

c. The entity filed the Form 10-Q or Form 10-QSB before the completion of the review.

In such circumstances, the accountant should communicate the matter(s) to the appropriate level of management as soon as practicable.

f. Paragraph 32 is replaced with—

If the auditor becomes aware of information indicating that fraud or an illegal act has or may have occurred, the auditor must also determine his or her responsibilities under AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[1]

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[1] See 15 U.S.C. §78j-1

g. Within paragraph 33, the third sentence is replaced with—

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting, that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

Auditing Standard No. 3, Audit Documentation

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

Within footnote 2 to paragraph 6, the reference to paragraphs 68–70 of Auditing Standard No. 2 is replaced with a reference to paragraphs 28–33 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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* is amended as follows—

a. Within note 1 to paragraph 1, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. Within paragraph 2, the two references to Auditing Standard No. 2 are replaced with references to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

c. Within the note to paragraph 2, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

d. Within paragraph 4, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

e. Paragraph 9 is replaced with—

> The terms *internal control over financial reporting*, *deficiency*, *significant deficiency*, and *material weakness* have the same meanings as the definitions of those terms in Appendix A, *Definitions,* of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

f. The first sentence of paragraph 10 is replaced with—

> Paragraph 5 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, states "[t]he 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."

g. Within the note to paragraph 10, the reference to Auditing Standard No. 2 in the first sentence is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and the last sentence is amended as follows—

> More information about the COSO framework is included within the COSO report.

h. Paragraph 11 is replaced with—

> The terms relevant assertion and control objective have the same meaning as the definitions of those terms in Appendix A, *Definitions*, of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

i. Paragraph 13 is replaced with—

> In an audit of internal control over financial reporting, the auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that

could result in material misstatements in the financial statements.[2]

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[2] See paragraph 42 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

j. Within the note to paragraph 17, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

k. Within note 2 to paragraph 18, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

l. Within paragraph 21, the last sentence is deleted.

m. Within paragraph 23, the reference to paragraphs 22 and 23 of Auditing Standard No. 2 is replaced with a reference to paragraph 20 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. Additionally, the second sentence is deleted.

n. Within paragraph 24, the reference to paragraph 39 of Auditing Standard No. 2 is replaced with a reference to paragraph 9 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

o. Within paragraph 25, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

p. Within the note to paragraph 25, the two references to Auditing Standard No. 2 are replaced with references to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

q. Within subparagraph a. of paragraph 26, the reference to paragraphs 47 through 51 of Auditing Standard No. 2 is replaced with a reference to paragraphs 22–27 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

r. Subparagraph b. of paragraph 26 is replaced with—

> Perform the procedures described in paragraphs 34–38 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, for those transactions that are directly affected by controls specifically identified by management as addressing the material weakness.

s. The note to subparagraph b. of paragraph 26 is deleted.

t. Within paragraph 27, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

u. The note to paragraph 28 is deleted.

v. Within paragraph 31, the reference to paragraphs 88 through 91 of Auditing Standard No. 2 is replaced with a reference to paragraphs 42–43 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

w. Paragraph 32 is replaced with—

> Consistent with the direction in paragraphs 44–45 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, the auditor should test the operating effectiveness of a specified control by determining whether the specified control operated as designed and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively. In determining the nature, timing, and extent of tests of controls, the auditor should apply paragraphs 50–54 of Auditing Standard No. 5.

x. Paragraph 33 is replaced with—

> The auditor should perform tests of the specified controls over a period of time that is adequate to determine whether, as of the date specified in management's assertion, the controls necessary for achieving the stated control objective are operating effectively. The timing of the auditor's tests should vary with the risk associated with the control being tested. For example, a transaction-based, daily reconciliation generally would permit the auditor to obtain sufficient evidence as to its operating effectiveness in a shorter period of time than a pervasive, entity-level control, such as any of those described in paragraphs 22–24 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. Additionally, the auditor typically will be able to obtain sufficient evidence as to the operating effectiveness of controls over the company's period-end financial reporting process only by testing those controls in connection with a period-end.

y. Within paragraph 35, the reference to paragraphs B1 through B13 of Appendix B of Auditing Standard No. 2 is replaced with a reference to paragraphs B10–B16 of Appendix B, Special Topics, of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

z. Within paragraph 36, the reference to paragraphs 109 through 115 and 117 through 125 of Auditing Standard No. 2 is replaced with a reference to 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*.

aa. The second sentence of paragraph 37 is replaced with—

> Therefore, if the auditor has been engaged to report on more than one material weakness or on more than one stated control objective, the auditor must evaluate whether he or she has obtained sufficient evidence that the control objectives related to each of the material weaknesses identified in management's assertion are achieved.

bb. The first two sentences of paragraph 38 are replaced with—

> Paragraphs 18–19 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, should be applied in the context of the engagement to report on whether a previously reported material weakness continues to exist.

cc. The note to paragraph 38 is deleted.

dd. The note to paragraph 39 is deleted.

ee. Paragraph 42 is replaced with—

> Management may conclude that a previously reported material weakness no longer exists because its severity has been sufficiently reduced such that it is no longer a material weakness.

ff. Subparagraph f. of paragraph 44 is replaced with—

> Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a misstatement in the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting and that has occurred or come to management's attention since the date of management's most recent annual assessment of internal control over financial reporting.

gg. Within the note to subparagraph b. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

hh. Within the note to subparagraph l. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

ii. Within the note to the second bullet point of subparagraph o. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

jj. Within paragraph 52, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

kk. Within paragraph 63, the reference to paragraphs 202 through 206 of Auditing Standard No. 2 is replaced with a reference to paragraphs 7 and 29–32 of AU sec. 722, *Interim Financial Information*.

ll. Within paragraph 64, the reference to paragraphs 202 through 206 of Auditing Standard No. 2 is replaced with a reference to paragraphs 7 and 29–32 of AU sec. 722, *Interim Financial Information.*

Appendix 4

Additional Discussion of Comments and the Board's Response

As discussed in the first part of the Board's release, on December 19, 2006, the Board proposed for comment a new standard on auditing internal control, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that would replace Auditing Standard No. 2, a related auditing standard, *Considering and Using the Work of Others in an Audit*, an independence rule relating to the auditor's provision of internal control-related non-audit services, and certain amendments to its auditing standards. The Board received 175 comment letters on its proposals and feedback from the Board's Standing Advisory Group.

Notable changes that the Board made in finalizing its proposals in response to comments are described in the first part of the Board's release. This appendix contains a further discussion of comments received on the proposals and the Board's response.

1. Alignment of Board's Internal Control Auditing Standard and the SEC's Guidance to Management

Many commenters suggested that the SEC's guidance to management and the Board's auditing standard should be more closely aligned. The commenters appeared to hold different opinions, however, about what alignment should mean in this context. Some commenters suggested that the most important issue was the need to use the same definitions of important terms in both documents. Some focused on perceived differences in scope, testing, and documentation requirements, while others suggested that the tone of the two documents was different and that the Board's proposals were more prescriptive. A few commenters suggested that the standard on auditing internal control should merely refer to the SEC management guidance without providing additional direction to the auditor.

As discussed more fully in the first part of this release, in formulating a new standard on auditing internal control, the Board intended to describe an audit process that would be coordinated with management's evaluation process. After considering the comments in this area, the Board made several changes, described in the first part of this release, that improve coordination while recognizing the inherent differences in the roles of management and the independent auditor under Section 404. The Board also adopted, as proposed, the final standard without a requirement for the auditor to perform an evaluation of management's assessment process. Commenters generally supported this aspect of the proposal, which was intended to respond to concerns that the requirements of Auditing Standard No. 2 had become de facto guidance for management's process. The absence of this requirement in the final standard should also allow for improved coordination between management and the auditor.

2. Level of Prescriptive Detail

Some commenters suggested that there remained too many instances of the use of the terms "should" and "must" in the proposed standard and that this might drive excessive documentation and possibly unnecessary work. The Board's

Rule 3101 describes the level of responsibility that these imperatives impose on auditors when used in PCAOB standards, and the Board uses these terms in its standards to clearly convey its expectations. In response to these comments, the Board analyzed each requirement in the proposed standard to determine whether more reliance could be placed on general principles rather than detailed requirements. Where appropriate, the Board made modifications to make the final standard more principles-based. As discussed more fully in the first part of this release, areas in which changes were made include the focus on fulfilling the objectives of a walkthrough and in the description of the top-down approach. Some of these changes also contributed to better coordination with the SEC's guidance for management.

In addition, several commenters expressed concern over the creation of presumptively mandatory responsibilities related to efficiency concepts. The example cited most often was the note to paragraph 3 of the proposed standard on auditing internal control, which stated—

> Note: The auditor should select for testing only those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to a given relevant assertion that could result in a material misstatement to the company's financial statements.

Commenters suggested that because of this requirement for the auditor to select "only those controls that are important" for testing, an auditor would have violated the Board's standards if he or she tested even one control that was later shown to be not important. Commenters believed that this would undermine audit effectiveness and recommended removal of such statements.

One of the objectives of the revised standard is to encourage auditors to focus on those areas that present the greatest risk of allowing a material misstatement in the financial statements. However, the Board agrees that its standards should not define a ceiling or maximum amount of work which the auditor may not exceed. While this statement (and others like it) in the proposed standard was not intended to imply that the Board would, with hindsight, suggest that an auditor violated the standard through testing of a control that was later determined to be not important to the audit, the Board has removed the note to paragraph 3 in response to these comments. Similar statements throughout the standard have also either been removed or modified.

3. Walkthroughs

The proposed standard required that the auditor perform a walkthrough of each significant process each year and allowed the auditor to use others, such as management personnel and internal auditors, to directly assist the auditor in this work. The proposed standard also indicated that the walkthrough provides audit evidence but did not prescribe further requirements regarding the circumstances in which a walkthrough might provide the auditor with sufficient evidence of operating effectiveness for a particular control. The proposing release, however, noted that a walkthrough could be sufficient for some low-risk controls in subsequent years.

As discussed in the first part of this release, the Board received a significant number of comments on this topic. While several commenters expressed support for the importance of the walkthrough to audit quality, many commenters suggested that the proposed provisions in this area were more prescriptive than necessary, and suggested risk concepts as a way to add flexibility. While these commenters acknowledged the value of a walkthrough and its importance to

the evaluation of design effectiveness, many stated that the requirement to perform a walkthrough in an area that is either low-risk, not complex, or unchanged appears inconsistent with the other areas in the proposed standard that rely upon auditor judgment to a much greater extent.

Use of others in achieving the objectives of a walkthrough

Commenters supported allowing the auditor to use others to provide the auditor with direct assistance, particularly in low-risk areas, with only a few commenters believing that this change could jeopardize the quality of the audit. In addition, many commenters believed that the standard should allow full use of the work of others in performing walkthroughs, although some commenters strongly disagreed with this point.

As discussed in the first part of this release, the final standard focuses the auditor on achieving four objectives related to the identification of where within the company's processes misstatements could arise, rather than specifically on performing walkthroughs. Due to the importance of achieving these objectives to the auditor's conclusion about internal control, the Board believes that allowing the use of the work of others to a greater extent than what was proposed would not provide the auditor with an adequate understanding of the relevant risks and the related controls. Therefore, similar to the proposed standard, Auditing Standard No. 5 allows the auditor to use the work of others in achieving the objectives of a walkthrough, but only as direct assistance. That is, the auditor will be required to supervise, review, evaluate, and test the work performed by others.[1]

Using walkthroughs to test operating effectiveness

On the subject of using walkthroughs to test operating effectiveness, commenters suggested that walkthroughs can provide sufficient evidence of operating effectiveness, but held different views about situations in which this would be the case. Some commenters supported the use of walkthroughs in low-risk areas, while others focused on whether the control itself should be low-risk. Several commenters suggested that a walkthrough could provide sufficient evidence of operating effectiveness for lower-risk controls but only when entity-level controls are strong. Almost all commenters agreed that the proposed standard focused on the appropriate conditions for using such an approach—specifically, when risk is low, when past audits indicate effective design and operation of the control, and when no changes have been made to the control or process in which the control resides.

After considering these comments, the Board has decided that the risk-based approach that is described in the final standard is the appropriate framework for determining the evidence necessary to support the auditor's opinion. Therefore, Auditing Standard No. 5 articulates the principle that performance of a walkthrough might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthroughs and the results of the procedures performed.[2] The Board believes that establishing more detailed requirements in this area is not necessary, because application of the general principle in the standard will depend on the particular facts and circumstances presented.

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[1] See paragraph 27 of AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.

[2] See paragraph 49.

4. Assessing Risk

The Board's May 16, 2005 guidance emphasized the importance of risk assessment in the audit of internal control, and that element of the guidance was incorporated and enhanced in the proposed standard. The proposed standard required risk assessment at each of the decision points in a top-down approach, including the auditor's identification of significant accounts and disclosures and their relevant assertions. The proposed standard also required an assessment of risk at the individual control level, and required that the auditor determine the evidence necessary for a given control based on this risk assessment.

The Board received many comments on the risk assessment provisions in the proposed standard. Comments on the proposed risk assessment approach were generally supportive, with some commenters suggesting ways for improving the risk assessment emphasis in the standard. Many commenters discussed the requirement in the proposed standard for the auditor to assess the risk that the control might not be effective and, if not effective, the risk that a material weakness would result for each control the auditor selected for testing. Commenters suggested that this requirement conflicted with both current practice and the requirements within the interim standards for the financial statement audit, which involve risk assessment at the financial statement assertion level. These commenters believed that this requirement would result in risk assessments at both the assertion level and the individual control level and suggested that assessing (and documenting) risk at the relevant assertion level is sufficiently precise to drive appropriate audits. Furthermore, they believed that a specific requirement to assess risk at the individual control level and its associated documentation requirement would be unnecessary.

After considering these comments, the Board continues to believe that the auditor may vary the nature, timing, and extent of testing based on the assessed risk related to a control. Making this assessment a presumptively mandatory requirement, as it was in the proposed standard, however, does not appear necessary to achieve the intended benefits of varied testing based on the risk associated with a control. Auditing Standard No. 5, therefore, requires the auditor to assess the risk related to the relevant assertion, but not the risk at the individual control level. The standard permits the auditor to consider the risk at the control level, however, and alter the nature, timing, and extent of testing accordingly.

Several commenters expressed concern about the advisability of taking a risk-based approach and the adequacy of the Board's interim standards regarding risk assessment. These commenters suggested that auditors have frequently been unsuccessful at applying a risk-based approach to the financial statement audit in the past.

The Board has found the arguments for a more principles-based approach to internal control auditing convincing, and the principle that the auditor should vary the testing to respond to the risk is one of the most important in the standard. Early implementation of Auditing Standard No. 2 demonstrated that, when internal control is audited without adequate consideration of risk, the areas that pose the greatest danger of material misstatement may be obscured or lost. The emphasis on risk, therefore, drives an audit that is more effective and focused. While the Board believes that auditors can appropriately assess risk based on the interim auditing standards, it has committed to examining the existing standards in this area to see where improvements can be made. This is currently one of the Board's standard setting priorities.

5. Evaluation of Deficiencies

The Board received a substantial number of comments on the topic of evaluating deficiencies, including comments on the proposed definitions of material weakness and significant deficiency, the "strong indicators" of a material weakness, and the requirement to evaluate all identified deficiencies. While a number of commenters stated that auditors do identify material weaknesses in the absence of an actual material misstatement, some noted that, in many cases, material weaknesses are identified only when material misstatements are discovered. Several commenters suggested that the proposed standard, with its focus on using a top-down approach and scoping to identify material weaknesses, would allow auditors to do a more thorough review of the most important controls with less effort expended on reviewing lower risk controls. These commenters often stated that this approach should increase the likelihood of the auditor detecting material weaknesses before a material misstatement occurs.

Definition of a material weakness

The proposed standard retained the basic framework in Auditing Standard No. 2 that described material weaknesses by reference to the likelihood and magnitude of a potential misstatement. While the Board believed that framework to be sound, it made an effort to clarify the definition in the proposed standard by replacing the reference to "more than remote likelihood" with "reasonable possibility." Financial Accounting Standards Board ("FASB") Statement No. 5 describes the likelihood of a future event occurring as "probable," "reasonably possible," or "remote." The definition in Auditing Standard No. 2 referred to a "more than remote" likelihood of a misstatement occurring. In accordance with FASB Statement No. 5, the likelihood of an event is "more than remote" when it is either "reasonably possible" or "probable."

As the Board noted in the proposing release, however, some auditors and issuers have misunderstood the term "more than remote" to mean something significantly less likely than a reasonable possibility. This, in turn, could have caused these issuers and auditors to evaluate the likelihood of a misstatement at a much lower threshold than the Board intended. Because the term "more than remote" could have resulted in auditors and issuers evaluating likelihood at a more stringent level than originally intended, the Board proposed changing the definition to refer to a "reasonable possibility."

Commenters on this change were split between those that felt the change would reduce unnecessary effort spent on identifying and analyzing deficiencies, and those who believed it would not. Several commenters noted that the replacement of the term "more than remote likelihood" with the term "reasonable possibility" does not raise the auditor's threshold for classifying deficiencies. According to those commenters, the change simply attempts to align the description of the threshold for identifying deficiencies with previous guidance issued by the PCAOB. The Board continues to believe that the proposed definition—as well as Auditing Standard No. 2—established an appropriate threshold for the likelihood part of the definition of material weakness. While the Board agrees that, as a definitional matter, "reasonable possibility" and "more than remote" describe the same threshold, it believes that "reasonable possibility" describes that threshold more appropriately and clearly, and will therefore avoid the misunderstanding of the threshold created by the way it was described in Auditing Standard No. 2. As a result, it retained that term in the final definition in the standard.

In addition, some commenters noted that the definitions of material weakness and significant deficiency in the proposed standard, like the definitions in Auditing Standard No. 2, referred to the likelihood of a material misstatement in

both the interim and annual financial statements. Most of these commenters suggested that the Board remove the term "interim" from the definitions of material weakness and significant deficiency because, according to the commenters, it causes confusion when scoping the audit of internal control and unnecessarily complicates the evaluation of deficiencies, particularly in the absence of guidance from the SEC and FASB regarding interim materiality. Some commenters, however, said that the Board should not remove the term "interim" from the definitions because the evaluation of deficiencies should be performed to consider the effectiveness of internal control for both the interim and annual financial statements. After carefully considering these comments, and in order to use the same definition that the SEC uses in its guidance to management, the Board determined to retain the reference to interim financial statements in the final definition of material weakness.[3]

Indicators of a material weakness

The proposed standard described circumstances that should be regarded as strong indicators of a material weakness in internal control. The proposing release noted that the identification of one of these strong indicators should bias the auditor toward a conclusion that a material weakness exists but does not require the auditor to reach that conclusion. Under the proposal, the auditor could determine that these circumstances do not rise to the level of a material weakness, and in some cases, are not deficiencies at all.

Many commenters supported the proposed changes from Auditing Standard No. 2 relating to strong indicators, agreeing that, by allowing greater use of professional judgment in this area, practice will improve. A few commenters stated that these changes may lead to some inconsistency in practice, but consistent with other commenters, they still supported the use of greater professional judgment in the evaluation of deficiencies. At least one commenter suggested that several of the strong indicators were not indicators of a material weakness but should be, under all circumstances, a material weakness. A few commenters also suggested that the list of strong indicators in Auditing Standard No. 2 actually stifles the auditor's judgment to the point that auditors fail to identify material weaknesses that exist because the deficiency is not on the list of strong indicators. These commenters suggested that removing the list of strong indicators entirely would be best.

The Board believes that auditor judgment is imperative in determining whether a deficiency is a material weakness and that the standard should encourage auditors to use that judgment. At the same time, the Board continues to believe that highlighting certain circumstances that are indicative of a material weakness provides practical information about the application of the standard. As a result, the Board has included this information in the final standard but has taken a more principles-based approach. Additionally, the Board has coordinated with the SEC so that the indicators in the auditing standard parallel those in the SEC's management guidance.

Rather than referring to "strong indicators," the final standard refers simply to "indicators" of material weakness.[4] The standard also makes clear that the list of indicators is not exhaustive and should not be used as a checklist. Specifically,

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[3] The provisions in the final standard relating to significant deficiencies are discussed in the first part of this release. As discussed in the first part of this release, the Board also made minor wording changes to the definition of material weakness in order to use the same definition as the SEC in its guidance to management and related rules.

[4] The Board included as an indicator the proposed standard's requirement to determine the level of assurance that would satisfy prudent officials in the conduct of their own affairs that they

(continued)

under the final standard, the presence of one of the indicators does not mandate a conclusion that a material weakness exists. At the same time, a deficiency that is not a listed indicator may be a material weakness.

The Board did not adopt as indicators in the final standard certain proposed strong indicators. The Board believes, as at least one commenter suggested, that some of these proposed strong indicators are better characterized as material weaknesses rather than as indicators of a material weakness.[5] Including them in the list of indicators, as adopted, would therefore be inconsistent with the degree of judgment required to evaluate whether an indicator of a material weakness is, under particular facts and circumstances, a material weakness.

Requirement to evaluate all identified deficiencies

The proposed standard required the auditor to evaluate the severity of each control deficiency that comes to his or her attention. The same provision in the proposed standard made clear, however, that the auditor need not scope the audit to find control deficiencies that are less severe than material weaknesses. A few commenters believed that this requirement is not necessary and suggested that an acceptable alternative would be for the auditor to verify that management has evaluated all deficiencies.

The Board continues to believe that the auditor needs to evaluate all deficiencies that come to his or her attention. Without such an evaluation, there would not be a sufficient basis for the auditor's opinion.

6. Additional Scoping and Materiality Issues

The proposed standard clarified that the auditor should plan and perform the audit of internal control using the same materiality measures used to plan and perform the audit of the annual financial statements. This direction was intended to address concerns that auditors have interpreted Auditing Standard No. 2 as directing them to search for potential defects in internal control at a lower materiality level than that used in the audit of the annual financial statements.

The Board received many comments on materiality and scoping, and a large portion of the commenters expressed support for the proposed standard's approach. Some commenters, however, recommended providing clear quantitative guidelines for calculating materiality. Other commenters expressed concern about such an approach, fearing that material areas would be inappropriately excluded from the audit scope. Finally, some commenters suggested that the

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(footnote continued)

have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. In the proposal, if the auditor determined that a deficiency would prevent prudent officials from concluding that they have such reasonable assurance, the auditor was required to deem the deficiency to be at least a significant deficiency. Under the final standard, if the auditor determines that a deficiency might prevent prudent officials from concluding that they have such reasonable assurance, this circumstance is an indicator of material weakness.

[5] One such proposed strong indicator was an ineffective control environment. Under the proposal, indicators of an ineffective control environment included identification of fraud on the part of senior management and significant deficiencies that have been communicated to management and the audit committee and remain uncorrected after some reasonable period of time. The final standard includes the identification of fraud on the part of senior management as an indicator of a material weakness. In order to simplify the list and make it more principles-based, as well as to align it with the SEC management guidance, however, the Board did not include significant deficiencies that remain uncorrected as an indicator in the final standard.

Board should provide additional guidance on scoping and extent of control testing decisions, such as guidance on sample sizes related to testing of high-risk controls versus low-risk controls or more specific guidance on the scope of the internal control audit for entities with multiple locations.[6]

After considering these comments, the Board has determined to adopt its discussion of materiality in the internal control audit as proposed. The Board believes that the auditing standard on internal control is an inappropriate place to redefine or refine the meaning of materiality, which is a long-established concept in the federal securities laws. With respect to requests for more specific guidance on scoping or extent of testing issues, the Board has, as discussed in the first part of this release, endeavored to adopt a standard that relies more on general principles than detailed requirements. Accordingly, the Board believes that auditors should make specific determinations of how to comply with the general scoping and testing requirements in the standard using professional judgment in the particular circumstances presented.

7. Scaling the Audit for Smaller Companies

As discussed in the first part of this release, the Board received many comments on the proposed section on scaling the audit from commenters with a variety of perspectives. The comments covered a wide range of issues. In addition to the matters discussed in the first part of this release, commenters suggested:

- That the proposed section on scalability should be focused more closely on how complexity relates to a risk-based audit;
- That the proposed standard did not provide sufficient flexibility for smaller companies and that the standard should provide for more "credit" for control testing based on work done as part of the financial statement audit;
- That the resulting costs of these proposed changes would need to be studied for several years to determine if they are appropriate;
- That the attributes of smaller, less complex companies that were included in the proposed standard were appropriate and that the tailoring directions for auditors were adequate;
- That some of the attributes of smaller, less complex companies that might allow the auditor to tailor the audit might be, instead, risk factors that require more testing;
- That the emphasis on entity-level controls might not be appropriate; and
- That the Board's project to develop guidance on auditing internal control in smaller public companies is necessary.

As discussed in the first part of this release, the Board made several changes in response to comments in the final standard. The new standard provides direction on how to tailor internal control audits to fit the size and complexity of the company being audited. It does so by including notes throughout the standard on how to apply the principles in the standard to smaller, less complex companies, and by including a discussion of the relevant attributes of smaller, less complex companies as well as less complex units of larger companies. The Board

[6] The proposed standard focused on the auditor's assessment of risk of material misstatement and how the auditor could carry that assessment process into the scoping of a multi-location audit. Commenters were very supportive of the Board's approach in this area and, consequently, the Board has determined to adopt these provisions as proposed.

believes that the final standard appropriately considers the circumstances of smaller and less complex public companies (and other companies with less complex business units) while requiring a high-quality audit regardless of company size or complexity. The planned guidance on this topic will provide additional practical information for auditors of smaller companies.

8. Information Technology Principles

In gaining an understanding of the effect of information technology ("IT") on internal control over financial reporting and the risks the auditor should assess, the proposed standard directed the auditor to apply guidance in AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*. Additionally, the proposed standard included a discussion of IT operations at smaller and less complex companies. A number of commenters discussed the importance of IT risks to determining the scope of the audit and recommended that the final standard include additional guidance on how the risk assessment related to IT is incorporated in the audit of internal control.

In response to these comments, the Board included in Auditing Standard No. 5 a note to paragraph 36 that clarifies that the identification of risks and controls within IT should not be a separate evaluation but, rather, an integral part of the auditor's top-down risk assessment, including identification of significant accounts and disclosures and their relevant assertions, as well as the controls to test.

9. Roll-forward Procedures

The proposed standard discussed the procedures the auditor should perform to obtain additional evidence concerning the operation of the control when the auditor reports on the effectiveness of the control "as of" a specific date, but has tested the effectiveness of the control at an interim date. The Board received a few comments on this topic, mainly from auditors. The comments were consistent in their view that the proposed standard improperly implies, by using the expression "if any" in relation to additional evidence the auditor is required to obtain, that the auditor may not need to do any roll-forward work. Commenters suggested that such an approach would be inconsistent with paragraph .99 of AU sec. 319 and suggested that the words "if any" be removed from the final standard. The Board believes that its standard should be consistent with AU sec. 319.99 in that the auditor should perform some level of roll-forward procedures. Consequently, the Board removed the words "if any" from the relevant paragraphs of Auditing Standard No. 5 to correct the inconsistency. The Board also noted that, in some circumstances, inquiry alone might be a sufficient roll-forward procedure.

10. Cumulative Knowledge and Rotation

The proposed standard on auditing internal control allowed the auditor to incorporate knowledge from previous years' audits into his or her decision making process for determining the nature, timing, and extent of testing necessary. The section in the proposed standard on special considerations for subsequent years' audits built upon the risk-based framework in the proposed standard for determining the nature, timing and extent of testing by describing certain additional factors for the auditor to evaluate in subsequent years. These factors included the results of prior years' testing and any change that may have taken place in the controls or the business since that testing was performed. This section retained the requirement in Auditing Standard No. 2 that each control deemed important to the auditor's conclusion be tested every year, but allowed

for a reduction in testing when the additional risk factors indicated that the risk was lower than in the past.

Many commenters strongly supported these provisions as proposed. Many investors, in particular, stated that while they supported the proposed approach, they would not be supportive of rotation of control testing over a multiple-year period. These commenters were generally concerned that rotation of control testing would negatively affect audit quality. Among supporters of the approach in the proposed standard, several requested further clarification in the standard or additional guidance on how this approach should affect the level of testing.

Many issuers suggested that the standard should allow for full rotation—which exempts some important controls from testing each year—of at least controls in low-risk areas. Other commenters recommended that all controls should be tested on a multiyear rotating basis. These comments often focused on the fact that while the proposed standard required the auditor to evaluate whether there had been any relevant changes since the control was tested, it still required testing at some level even when there had been no change. These commenters considered this requirement to be unnecessary.

The Board shares the concern that multi-year rotation of control testing would not provide sufficient evidence for the auditor's opinion on internal control effectiveness, which is required by the Act to be issued each year. In the financial statement audit, control testing plays a supporting role—to the extent that controls have been tested and are effective, the auditor can reduce the level of (but not eliminate) the necessary substantive testing. In contrast, in the internal control audit, control testing does not play a supporting role but is the sole basis for the auditor's opinion. Additionally, even if the design of the control and its related process does not change from the prior year, it is not possible to assess the control's operating effectiveness without performing some level of testing. For these reasons, rotation is not a viable option in the audit of internal control.

Instead, the approach described in the proposed standard has been clarified in the final standard and continues to focus the auditor on relevant changes since a particular control was last tested, as many commenters suggested. Under this approach, the auditor would consider, in addition to the risk factors described in the standard that are always relevant to determining the nature, timing, and extent of testing, whether there has been a change in the controls or in the business that might necessitate a change in controls; the nature, timing, and extent of procedures performed in previous audits; and the results of the previous years' testing of the control.[7] After taking into account these additional factors, the additional information in subsequent years' audits might permit the auditor to assess risk as lower than in the initial year and, thus, might permit the auditor to reduce testing.

This treatment of cumulative knowledge is analogous to the roll-forward provisions in the final standard. In the case of subsequent years, the auditor, in essence, rolls forward the prior years' testing when the control was found to be effective in the past and no change has occurred (or would have been expected to occur due to changes in the environment or process that contains the control). Because the auditor might be able to assess the risk lower in the subsequent years, a walkthrough, or equivalent procedures, might be sufficient for low-risk controls. This approach appropriately factors in the effect of cumulative knowledge, while maintaining audit quality and providing a sufficient basis for the auditor's opinion.

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[7] See paragraph 55.

11. Reporting the Results of the Audit

In the proposed standard, the Board attempted to address concerns that the separate opinion on management's assessment required by Auditing Standard No. 2 contributed to the complexity of the standard and caused confusion regarding the scope of the auditor's work.[8] Accordingly, to emphasize the proper scope of the audit and to simplify the reporting, the proposed standard required that the auditor express only one opinion on internal control—a statement of the auditor's opinion on the effectiveness of the company's internal control over financial reporting. The proposal eliminated the separate opinion on management's assessment because it was redundant of the opinion on internal control itself and because the opinion on the effectiveness of controls more clearly conveys the same information—specifically, whether the company's internal control is effective.

Many commenters agreed with the Board that eliminating the separate opinion on management's assessment would reduce confusion and clarify the reporting. Some commenters, however, suggested that the Board should instead require only an opinion on management's assessment. These commenters expressed their belief that the Act requires only that the auditor review management's assessment process and not the company's internal control. Additionally, a few commenters expressed confusion about why the proposed standard continued to reference an audit of management's assessment in paragraph 1 of the proposed standard and the auditor's report.

The Board has determined, after considering these comments, to adopt the provision requiring only an opinion on internal control.[9] The Board continues to believe that the overall scope of the audit that was described by Auditing Standard No. 2 and the proposed standard is correct; that is, to attest to and report on management's assessment, as required by Section 404(b) of the Act, the auditor must test controls directly to determine whether they are effective.[10] Accordingly, paragraphs 1 and 2 of the proposed standard provided that the auditor audits management's assessment—the statement in management's annual report about whether internal control is effective—by auditing whether that statement is correct—that is, whether internal control is, in fact, effective. The final standard similarly makes this clear. In response to commenters, however, the Board has clarified the auditor's report so that it will consistently refer to the required audit as the audit of internal control.

12. Implementation

Some commenters urged the Board to focus on implementation issues after it adopts a final standard, and noted that effective implementation by the Board is crucial to the internal control reporting process. Some of these commenters focused on the inspections process, which they suggested is key to promoting

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[8] Although Auditing Standard No. 2 requires the auditor to evaluate management's process, the auditor's opinion on management's assessment is not an opinion on management's internal control evaluation process. Rather, it is the auditor's opinion on whether management's statements about the effectiveness of the company's internal controls are fairly stated.

[9] The SEC has adopted changes to its rules that require the auditor to express an opinion directly on internal control.

[10] In addition, Section 103 of the Act requires the Board's standard on auditing internal control to include "testing of the internal control structure and procedures of the issuer ...." Under Section 103, the Board's standard also must require the auditor to present in the audit report, among other things, "an evaluation of whether such internal control structure and procedures ... provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles ...."

audit efficiency. Some stated that auditors would be unlikely to change their audit approach until they are confident that the inspections will be similarly focused. The Board is committed to effective monitoring of firms' compliance with the new standard and will continue to promote proper implementation through other means, including the Board's Forums on Auditing in the Small Business Environment and guidance for auditors of smaller companies.

PCAOB Release No. 2008-001

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

PCAOB Release No. 2008-001
January 29, 2008
PCAOB Rulemaking
Docket Matter No. 023

Summary

After public comment, the Public Company Accounting Oversight Board is adopting Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, and amendments to the Board's interim auditing standards.

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A. Introduction

The Board proposed certain changes to its auditing standards in response to two actions of the Financial Accounting Standards Board ("FASB"). In May 2005, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 154, *Accounting Changes and Error Corrections*,[1] which superseded Accounting Principles Board ("APB") Opinion No. 20, *Accounting Changes*.[2] The FASB has also issued an exposure draft of a proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles.*[3]

SFAS No. 154 establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to a newly adopted accounting principle.[4] SFAS No. 154 also redefines the term "restatement" to refer only to "the process of revising previously issued financial statements to reflect the

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[1] Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Standards ("SFAS") No. 154, *Accounting Changes and Error Corrections* (2005) ("SFAS No. 154").

[2] Accounting Principles Board ("APB") Opinion No. 20, *Accounting Changes* (1971). SFAS No. 154 also superseded SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*.

[3] FASB, Proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles,* Exposure Draft (April 2005).

[4] Among other reasons for undertaking this project, the FASB intended to eliminate differences between APB Opinion No. 20 and the International Accounting Standards Board standard, IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. See introduction to SFAS No. 154.

correction of an error in those financial statements."[5] Under SFAS No. 154, therefore, the term "restatement" does not refer to changes made to previously issued financial statements to reflect a change in accounting principle.

AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*, the Board's interim standard on the auditor's responsibilities for evaluating the consistency of the application of generally accepted accounting principles ("GAAP"), generally reflected the provisions of APB Opinion No. 20, which was superseded by SFAS No. 154. To better align the Board's standards with the new accounting standard, on April 3, 2007, the Board proposed a new auditing standard on evaluating consistency, which would supersede AU sec. 420, and conforming amendments to AU sec. 508, *Reports on Audited Financial Statements*, of its interim auditing standards.

The FASB's proposed standard on the GAAP hierarchy would incorporate the hierarchy found in the auditing standards into the accounting standards. Historically, a description of the GAAP hierarchy has resided only in the auditing standards.[6]

Because the GAAP hierarchy identifies the sources of accounting principles and the framework for selecting principles to be used in preparing financial statements, the Board believed that these requirements are more appropriately located in the accounting standards. Accordingly, also on April 3, 2007, the Board proposed to remove the GAAP hierarchy from the auditing standards.[7]

The proposed standard provided direction for the auditor's evaluation of the consistency of financial statements. It directed the auditor to recognize a change in accounting principle or an adjustment to correct a misstatement[8] in previously issued financial statements in the auditor's report if it had a material effect on the financial statements. The conforming amendments to AU sec. 508, *Reports on Audited Financial Statements*, provide language for the explanatory paragraph. The proposed standard also directed the auditor to review a material change in financial statement classification and the related disclosure to determine whether the change also is a change in accounting principle or a correction of a material misstatement.

The proposed standard and amendments were intended to update and clarify the auditing standards in light of SFAS No. 154 and the FASB's proposal on the GAAP hierarchy. In particular, these updates and clarifications should enhance the clarity of auditor reporting on accounting changes and corrections of misstatements by distinguishing between these events.

The Board received 11 comment letters. In general, the commenters were supportive of the proposed standard and amendments. They generally stated that the proposed auditing standard appropriately described how the auditor should evaluate the consistency of financial statements and reflected the changes to accounting requirements under SFAS No. 154. Several commenters suggested

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[5] See SFAS No. 154, paragraph 2j.

[6] See AU sec. 411, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles*." Although the Board is removing the GAAP hierarchy from this standard, the standard remains in existence, as amended.

[7] If the amendments are approved by the SEC, the effective date for the removal of the GAAP hierarchy from the auditing standards will be 60 days after the standard and amendments are approved by the SEC. The Board has coordinated with the FASB and understands that the FASB intends to coincide the effective date of its standard on the GAAP hierarchy with that of the PCAOB.

[8] SFAS No. 154 uses the term "error" instead of "misstatement." This release, including the final standard and amendments, uses "misstatement," the prevailing term used in PCAOB auditing standards. The term "error," as used in SFAS No. 154, is equivalent to "misstatement," as used in the auditing standards.

clarifications in various parts of the standard. As described in the following sections, the Board has considered the comments and made changes to the final standard and amendments.

The Board is adopting the proposed standard as Auditing Standard No. 6, as well as the amendments to the interim standards. This release describes key aspects and elements of the new standard and amendments, comments received, and changes incorporated in the final standard.

B. Evaluating Consistency

Under Auditing Standard No. 6, auditors are required to evaluate the consistency of a company's financial statements and report on inconsistencies. The new standard updates these requirements and aligns them more closely with SFAS No. 154[9] by requiring the auditor's report to recognize a company's correction of a material misstatement, regardless of whether it involves the application of an accounting principle. Based on a discussion at an October 2005 meeting of the Board's Standing Advisory Group, the Board understands that this requirement is consistent with current practice. The new standard focuses on the auditor's responsibilities regarding events that warrant recognition in the auditor's report on the financial statements–changes in accounting principles and corrections of misstatements in previously issued financial statements.[10] This standard also clarifies that the auditor's report should indicate whether an adjustment to prior-period financial statements results from a change in accounting principle or the correction of a misstatement.

1. Materiality

There were several comments on materiality. Some commenters suggested that the standard should specifically state that the auditor need not recognize the correction of a misstatement that is immaterial to the previously issued financial statements. Another suggested that the standard should remind the auditor that professional judgment is required to evaluate consistency. Another commenter said that additional guidance on materiality as applied to individual matters in the financial statements would be helpful in applying the standard. Others suggested that clarity would be improved by inserting the word "material" in several places.

In general, the Board's view is that the purpose of the standard is to provide direction on evaluating consistency; for example, the accounting periods the auditor should evaluate, the recognition in the auditor's report of consistency matters prescribed by the accounting standards, and the related audit reporting requirements. Because an audit is predicated on the use of reasoned judgment and the consideration of materiality in planning, performing, and reporting on the audit, the Board does not believe it is necessary for this standard to specifically direct the auditor to exercise judgment and apply materiality. Further, materiality is a concept that is defined under the federal securities laws, and it is not the objective of this standard to alter or interpret that concept.

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[9] Because SFAS No. 154 provides comprehensive, authoritative accounting guidance on changes in accounting principle and corrections of errors, Auditing Standard No. 6 omits the accounting guidance that was included in AU sec. 420.

[10] AU sec. 420 also required recognition of those events. However, it only required recognition in the auditor's report of the correction of a misstatement involving an accounting principle. In addition, unlike AU sec. 420, the new standard does not describe the accounting changes that do not require recognition in the auditor's report.

The Board did agree that clarity could be improved in some areas by inserting the word "material" to modify the word "misstatement." The Board added "material" to AU secs. 508.18A and B to be consistent with paragraph 4 of Auditing Standard No. 6. However, AU sec. 508.18C does not include "material" because that sentence summarizes the SFAS No. 154 requirement for correcting a misstatement, which does not directly mention materiality.

2. Periods Covered by the Evaluation of Consistency

The new standard describes the scope of the required evaluation of consistency in terms that are similar to the description in AU sec. 420. Under the new standard, when the auditor reports only on the current period, the auditor should evaluate whether the financial statements of the current period are consistent with those of the preceding period. When the auditor reports on two or more years, the auditor should evaluate whether the financial statements reported on are consistent with each other and with the prior year's financial statements, if presented. For example, assume that a company presents comparative financial statements covering three years and has a change in auditors. In the first year in which the successor auditor reports, the successor auditor evaluates consistency between the year on which he or she reports and the immediately preceding year. In the second year in which the successor auditor reports, the successor auditor would evaluate consistency between the two years on which he or she reports and between those years and the earliest year presented. In response to comments, the Board added this example to the final standard.

When a company uses retrospective application, as defined in SFAS No. 154, to account for a change in accounting principle, the financial statements presented generally will be consistent. However, the previous years' financial statements presented with the current year's financial statements will reflect the change in accounting principle and, therefore, will appear different from those previous years' financial statements on which the auditor previously reported. For example, consider a company that adopts a new accounting standard in 2007 that requires retrospective application to 2006 and 2005. The financial statements for 2006 and 2005 will be consistent, as presented with 2007. However, the financial statements for the years 2006 and 2005 that were issued a year earlier will not reflect the retrospective application and hence will not be consistent with 2007 and will be different from the 2006 and 2005 financial statements that are presented with 2007. The new standard clarifies that the auditor's evaluation of consistency should encompass previously issued financial statements for the relevant periods.

Paragraph 3 of the proposed standard described the financial statement periods covered by the evaluation of consistency. The third sentence of that paragraph was intended to be a clarification of the requirement in AU sec. 420.22 regarding the evaluation of two or more years. However, some commenters found the third sentence of paragraph 3 to be confusing and recommended retaining the language in AU sec. 420.22, unless the Board had intended to change the auditor's responsibilities for evaluating the consistency of GAAP. Because the Board wanted to be clear that the auditor's responsibilities had not changed, the Board decided to retain the original sentence from AU sec. 420.22, with some changes, instead of the proposed third sentence of paragraph 3. The inserted sentence, adapted from AU sec. 420.22, reads as follows (additions underlined and deletions struck through):

> When the ~~independent~~ auditor reports on two or more periods~~years~~, he or she should evaluate~~addressthe~~ consistency ~~of the application of accounting principles~~ between such periods~~years~~ and the consistency of such periods~~years~~

with the period~~year~~ prior thereto if such prior period~~year~~ is presented with the financial statements being reported upon.

The Board did not include the reference to "the application of accounting principles" because paragraph 3 also relates to the auditor's evaluation of a company's correction of a material misstatement, regardless of whether it involves the application of an accounting principle. The Board also used the word "evaluate" because it describes the auditor's responsibilities consistently with the rest of the paragraph.

Two commenters suggested that the last sentence of proposed paragraph 3, which described the auditor's responsibility to evaluate whether the financial statements are consistent with previously issued financial statements for the same period, was confusing and unnecessary. These commenters suggested deleting the last sentence of paragraph 3. In addition, one commenter suggested that paragraph 3 of the proposed standard could be clarified by including the explanatory language from the proposing release regarding retrospective application under SFAS No. 154. As discussed above, the new standard is intended to clarify that the auditor's evaluation of consistency should include an evaluation of previously issued financial statements for the relevant periods. Accordingly, the Board believed that the final sentence of paragraph 3 is necessary. However, the Board agreed that including the suggested explanatory language from the proposing release regarding retrospective application would clarify the paragraph and has added that language as a footnote to paragraph 3.

3. Reference to Application of Accounting Principles

Consistent with the discussion above related to paragraph 3 of the proposed standard, the Board also removed the reference to "application of accounting principles" from the first paragraph of Auditing Standard No. 6. Because the auditor's evaluation of consistency under this standard includes errors not involving an accounting principle, the consistency evaluation is broader than that described under the second standard of reporting. Accordingly, the Board also removed the reference to the second standard of reporting from paragraph 2 of Auditing Standard No. 6.

4. Change in Accounting Principle

The new standard requires the auditor to evaluate a change in accounting principle[11] that has a material effect on the financial statements to determine whether: (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with GAAP, (3) the disclosures related to the accounting change are adequate, and (4) the company justifies that the alternative accounting principle is preferable,[12] as required by SFAS No. 154.[13] Under the amendments

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[11] The proposed and final standards use the definition of a change in accounting principle found in SFAS No. 154, paragraph 2c.

[12] In certain circumstances, Securities and Exchange Commission ("SEC") rules require issuers to file a letter from the auditor indicating whether or not a change is to an alternative accounting principle that is preferable. See Rule 10-01(b)(6) of Regulation S-X, 17 C.F.R. § 210.10-01(b)(6).

[13] Under SFAS No. 154, the issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle as long as the change in accounting principle is made in accordance with the GAAP hierarchy. See SFAS No. 154, paragraph 14.

to AU sec. 508, if the four criteria are met,[14] the auditor would recognize the change in accounting principle in the auditor's report through the addition of an explanatory paragraph consisting of an identification of the nature of the change and a reference to the issuer's note disclosure describing the change. If those criteria are not met, the auditor would issue a qualified or adverse opinion.[15]

Some commenters recommended that the Board reconsider whether it was necessary for the auditor to recognize in the audit report changes that result when a company is required to adopt a newly issued accounting standard. They indicated that the significance of a company's discretionary change in accounting principle may be diluted if the auditor recognizes both discretionary changes and those changes in accounting principles required by a newly-issued standard in the report. Another commenter suggested that the auditor should not be required to include an explanatory paragraph in the audit report when changes in accounting principle have been applied retrospectively because, in such cases, the financial statements included in the filing will appear consistent. As noted above, the Board believes that it is important for investors to be informed when the prior year financial statements presented with the current year are different from previously issued financial statements. In addition, the Board believes that the different language in the auditor's report for discretionary changes and those required by a newly-issued standard provides sufficient notification to investors of the general nature of the change. Therefore, the Board adopted the requirement as proposed.[16]

One commenter suggested that the proposed standard deleted useful information about a change in accounting principle that also involves a change in an estimate. The proposed standard did not carry forward the requirement of AU sec. 420.13 that the auditor should recognize in his or her report a change in accounting principle that is inseparable from a change in estimate. After considering this comment, the Board concluded that the requirement in AU sec. 420.13 does result in useful information being included in the auditor's report. Accordingly, the Board updated the language in AU sec. 420 to reflect the term used in SFAS 154, and included the requirement in Auditing Standard No. 6.[17]

Some commenters asked the Board to clarify the reporting requirement related to a change in reporting entity. According to AU sec. 420.08, a change in reporting entity resulting from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit, does not require that the auditor include an explanatory paragraph in the auditor's report. Under the proposed standard, the auditor may have been required to report on, for example, the disposition of a subsidiary or business unit because SFAS No. 154 (and its predecessor, APB Opinion No. 20) did not specifically exempt such a transaction from the definition of a change in

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[14] The auditor has substantially the same responsibility for evaluating a change in accounting principle as under AU sec. 431, *Adequacy of Disclosure in Financial Statements*, and paragraph .50 of AU sec. 508, *Reports on Audited Financial Statements*. The language in Auditing Standard No. 6 has, however, been updated to be consistent with SFAS No. 154.

[15] This responsibility is substantially unchanged from AU sec. 508.51.

[16] In addition, one commenter suggested that the standard include an example of a change in the method of applying an accounting principle. The final standard, like the proposed standard, notes that under SFAS No. 154 a change in the method of applying an accounting principle is also a change in accounting principle. While the Board believes that it is helpful for the standard to reference the accounting requirement, it also believes that it is not appropriate for the auditing standard to provide accounting guidance.

[17] The new standard uses the term "change in accounting estimate effected by a change in accounting principle," which is defined in SFAS No. 154 as "a change in accounting estimate that is inseparable from the effect of a related change in accounting principle."

reporting entity. Generally, dispositions or spin-offs have specific disclosure requirements in the accounting standards and the Board did not intend to change practice and require the auditor to report on these events through an explanatory paragraph. Accordingly, the Board carried forward the requirement from AU sec. 420.08 regarding a transaction or event. In addition, the Board also added a reference to paragraph 2f in SFAS No. 154, which describes a change in reporting entity, as suggested by some commenters.

In response to comments, the Board also modified paragraph 8 of the proposed standard, which provided direction for reporting a change in accounting principle. Some commenters noted that the proposed conforming amendments to AU sec. 508.17 had a more clearly stated version of the number of years that the auditor is required to include an explanatory paragraph related to a change in principle than did footnote 5 to paragraph 8. After considering the commenters' recommendation that the language in the footnote be changed, the Board decided that the footnote was not necessary because paragraph 8 referred the auditor directly to the reporting requirements in AU sec. 508. The Board therefore removed footnote 5 from the final standard.

5. Correction of a Material Misstatement in Previously Issued Financial Statements

Under Auditing Standard No. 6, the correction of a material misstatement in previously issued financial statements (i.e., a "restatement") is recognized in the auditor's report through the addition of an explanatory paragraph. Under the conforming amendments to AU sec. 508, the explanatory paragraph in the auditor's report regarding a restatement should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. The first statement in the explanatory paragraph distinguishes restatements from adjustments to prior-period financial statements resulting from changes in accounting principle. Previously, the auditor's responsibilities for reporting on most restatements were the same as for reporting on changes in accounting principle.

One commenter suggested that the proposed standard did not clearly explain whether corrections of an error not involving a principle would require recognition in the auditor's report. Unlike the previous requirement, the proposed standard did not distinguish between the "correction of an error in principle" and an "error correction not involving a principle."[18] Rather, the proposed standard required recognition in the auditor's report of any correction of a material misstatement, whether or not the error involved a principle. The Board reconsidered the language and concluded that the requirement as proposed was sufficiently clear. The new standard aligns the auditor's reporting responsibilities with the accounting standards, which require disclosure of all restatements, by requiring an explanatory paragraph when the company has restated the financial statements.

Some commenters suggested that it would not improve clarity to have the auditor's report include a statement that the financial statements were restated "to correct a material misstatement." They noted that SFAS No. 154 already defines a restatement as the revision of previously issued financial statements to reflect the correction of an error. The Board decided to retain the reporting

[18] This distinction previously was in paragraphs .12 and .16 of AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*.

requirement as proposed because it clearly distinguishes corrections of misstatements from changes in accounting principle. Also, the required reporting language regarding restatements is more informative because it does not rely entirely on the user's knowledge of the definition of "restatement" in the accounting standard.[19]

One commenter also recommended that the auditor's explanatory paragraph about the correction of a misstatement should contain additional information. The commenter recommended that the explanatory paragraph include a statement that (1) the previously issued auditor's report should not be relied on because the previously issued financial statements were materially misstated, and (2) the previously issued report is replaced by the auditor's report on the restated financial statements.

The Board believes that the recommended additional language is not necessary because existing PCAOB standards and rules of the Securities and Exchange Commission ("SEC") are sufficient to inform users about misstatements in previously issued financial statements. Specifically, AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, requires the auditor to take specific action when he or she concludes that information discovered after the financial statements have been issued would have affected his or her report if the company had not reflected the information in the financial statements and people are currently relying or are likely to rely on the financial statements and auditor's report. According to AU sec. 561.06, the auditor should advise the company to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently relying or who are likely to rely on the financial statements and the related auditor's report.[20]

A U.S. public company that is not a foreign private issuer under SEC rules also is required to file a Form 8-K current report, if it concludes that any previously issued financial statements should no longer be relied upon because of an error in such financial statements.[21] If the auditor has notified the issuer that action should be taken to prevent future reliance on a previously issued audit report, the company also must disclose that information in the Form 8-K.

6. Changes in Classification

Auditing Standard No. 6 does not require the auditor's report to recognize a change in classification[22] in previously issued financial statements, except for a reclassification that is also a change in accounting principle or correction of a material misstatement.[23] Accordingly, the new standard clarifies that the

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[19] Two commenters suggested that the standard include the explanation from the release that the term "error," as used in SFAS No. 154, is equivalent to "misstatement," as used in the auditing standards. The Board agreed and has included that explanation in the final standard.

[20] AU sec. 561.06 also requires that if the effect on the financial statements or auditor's report can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and auditor's report. If issuance of the financial statements with an auditor's report for a later period is imminent, a company is permitted to disclose the revision to the financial statements instead of reissuing earlier statements. When the effect on the financial statements cannot be determined without a prolonged investigation, appropriate disclosure would consist of notification that the financial statements and auditor's report should not be relied on and that revised financial statements and auditor's report will be issued upon completion of an investigation.

[21] See Securities Exchange Act Rule 13a-11, 17 C.F.R. § 240.13a-11.

[22] AU sec. 420.17 also did not require recognition of a change in financial statement classification in the auditor's report.

[23] SFAS No. 154 uses the term "presentation" in its definition of an error in previously issued financial statements. The directions in paragraph 11 of the new standard address the auditor's

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auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change is also a change in accounting principle or a correction of a material misstatement. For example, in some circumstances, a change in financial statement classification also may be the correction of a misstatement. A restatement to correct the misclassification of an account as short- or long-term or misclassification of cash flows would be both a restatement and reclassification. Therefore, the auditor should evaluate these matters as part of the evaluation of corrections of misstatements. Under Auditing Standard No. 6, a classification change that is also a change in accounting principle should be reported on as a change in accounting principle, and a classification change that is also a correction of a material misstatement should be reported on by the auditor as a restatement.

Some commenters recommended slight revisions to the first sentence of paragraph 11 to clarify the auditor's responsibilities. The first sentence stated that changes in classification in previously issued financial statements do not require recognition in the auditor's report. This seemed to conflict with the second sentence which required the auditor to review a material change in classification and related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. The Board agreed with the comments and modified the first sentence to state that a change in classification does not require audit report recognition unless the change represents the correction of a material misstatement or a change in accounting principle. Additionally, in the proposed standard, the Board used the word "review" to describe the auditor's responsibility when there has been a material change in financial statement classification. The Board concluded that the word "evaluate" better describes the auditor's responsibilities in this area and is more consistent with the other requirements in Auditing Standard No. 6. Accordingly, the Board replaced "review" with "evaluate."

C. Description of GAAP and Removal of the GAAP Hierarchy From the Auditing Standards

As discussed previously, the FASB has proposed to incorporate the GAAP hierarchy into its own standards. The Board believes that it is appropriate to locate the GAAP hierarchy in the accounting standards rather than in the auditing standards. Thus, the Board amended its interim standards to remove the GAAP hierarchy from the auditing standards. These amendments do not change the principles in AU sec. 411 for evaluating fair presentation of the financial statements in conformity with GAAP.

Commenters strongly supported removing the GAAP hierarchy from the auditing standards and stated that it was appropriate for the GAAP hierarchy to be contained in the accounting standards. However, one commenter observed that the proposed amendments contain significant differences from the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's ("ASB") proposed amendment to AU sec. 411 of the ASB's standards.[24]

(footnote continued)

responsibilities for changes in classification, which is an element of the presentation and disclosure financial statement assertion under the auditing standards. See, e.g., paragraph .08 of AU sec. 326, *Evidential Matter*.

[24] In addition, this commenter suggested that U.S. auditing standard-setters should work together to achieve consistency on core auditing standards that are used by almost all auditors of U.S. entities. This commenter also suggested that if the Board continues issuing its own standards for audits

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The Board believes that the amendments to AU sec. 411 are consistent with the Board's objective of removing the GAAP hierarchy from the auditing standards, and retaining, or providing, direction necessary for audits of public companies. The significant differences between the ASB's amendments to its AU sec. 411 and the Board's amendments primarily are related to sources of GAAP for governmental entities and direction on the application of accounting principles, which the Board did not believe was appropriate for inclusion in the proposed amendments. In addition, the Board deleted references to Rule 203 of the AICPA's *Code of Professional Conduct*. Rule 203 prohibits auditors from expressing an opinion on financial statements that do not conform to GAAP unless the auditor can demonstrate that due to unusual circumstances the financial statements would have been misleading without departing from GAAP. In 2003, when the Board adopted certain AICPA rules and ASB standards as interim Board standards, the Board did not adopt Rule 203. Consistent with that action, the proposed amendments did not include a reference to Rule 203.

D. Section-by-Section Description of Amendments to the Interim Auditing Standards

In addition to proposing an auditing standard on evaluating consistency of financial statements, the Board also proposed amendments to other interim auditing standards and related interpretations. The following sections describe key aspects and elements of the amendments to the standards and interpretations, comments received, and changes incorporated in the final amendments.

AU sec. 410, Adherence to Generally Accepted Accounting Principles

The Board proposed to delete AU sec. 410.02 which discussed the meaning of "generally accepted accounting principles" and included other matters that are addressed elsewhere in the standards. However, some commenters suggested that, to improve clarity, AU sec. 410 should retain the sentence in existing AU sec. 410.02 which states that the "first standard is construed not to require a statement of fact by the auditor but an opinion."

The Board agreed that, when viewed alone, the first standard of reporting, contained in AU sec. 410.01, does not provide a complete description of the auditor's responsibilities related to fair presentation in conformity with GAAP. However, the first standard of reporting combined with the fourth standard clearly indicates that that the auditor is providing a statement of an opinion and not a statement of fact. The fourth standard of reporting provides that the auditor's report shall contain either an expression of opinion regarding the financial statements taken as a whole, or an assertion to the effect that an opinion cannot be expressed. To emphasize that the first and fourth reporting standards must be read together, the Board is including the fourth standard of reporting in the final amendment to AU sec. 410. However, as proposed, the prior statement on the meaning of "generally accepted accounting principles" has been deleted from AU sec. 410.02.

(footnote continued)

of public companies, it should adopt alternative numbering/referencing schemes in order to reduce confusion between its interim standards and the AICPA standards. The Board is considering these comments as it seeks to make continuous improvements to its standard-setting and other programs.

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

The Board proposed to delete AU sec. 411.02, which was a detailed description of GAAP, and AU secs. 411.05, .07 and .09-.15, which described the application of the GAAP hierarchy. The Board proposed to replace the description of GAAP in AU 411.02, with a statement that GAAP refers "to the accounting principles recognized in the standards of the Financial Accounting Standards Board or in the standards of any other standard-setting body recognized by the U.S. Securities and Exchange Commission."

However, commenters had concerns about the proposal. One commenter noted that the SEC might allow companies to file financial statement prepared in conformity with international financial reporting standards ("IFRS") but not recognize the International Accounting Standards Board, which issues IFRS, as a standard-setting body. Another commenter suggested that to avoid potential confusion by users, the Board should acknowledge that there are other sources of GAAP for entities other than public companies.

In response to these comments, the Board decided to modify its proposed amendment of AU 411. It deleted AU sec. 411.02, which described GAAP, and revised AU sec. 411.01 to indicate that the auditor should look to the requirements of the SEC for the company under audit to identify the accounting principles that are applicable to that company. This change should also clarify that the standard is focused only on the accounting principles that may be used for purposes of the federal securities laws. Other accounting principles may apply to financial statements prepared for other purposes or by entities that are not issuers. The Board also modified AU 411.01 to better emphasize that standard's focus on the meaning of the phrase "present fairly."

Finally, as proposed, the Board eliminated AU secs. 411.16 and .17 which set an effective date and transition requirements that are no longer applicable.

AU sec. 420, Consistency of Application of Generally Accepted Accounting Principles

AU sec. 420 has been superseded by Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*. However, some commenters suggested that parts of AU sec. 420 should have been incorporated into Auditing Standard No. 6. Commenters suggested that guidance on the objective of the consistency standard and the relationship of consistency and comparability, matters that may not affect consistency, and changes expected to have a material future effect provided useful direction.

The Board believes that it is unnecessary to include the preceding direction. The proposed standard clarified that the auditor's report should recognize only those matters that require recognition under the existing auditing standards—i.e., a change in accounting principle or the correction of a material misstatement. The Board does not believe it is necessary to list in a standard those matters that do not require recognition in the auditor's report. Also, the Board believes that paragraph 1 clearly describes the objective of the standard. Paragraph 2 makes it clear that the standard considers comparability to be between periods for the company under audit.

AU sec. 431, Adequacy of Disclosure in Financial Statements

AU sec. 431 describes the auditor's responsibilities for evaluating the adequacy of disclosures in the financial statements. The amendments address two technical matters relating to that section.

Footnote 1 to AU sec. 431.03 is not consistent with the SEC's independence rules regarding non-audit services and therefore has been eliminated.

AU sec. 431.04 is an application of the AICPA's *Code of Professional Conduct* regarding the disclosure of confidential client information. In 2003, when the Board adopted certain AICPA rules and ASB standards as interim Board standards, the Board did not adopt Rule 301. Consistent with that action, the proposed amendments would eliminate AU sec. 431.04.

Some commenters expressed concerns that the proposed elimination of AU sec. 431.04 would change the auditor's obligations, or reflected Board policy, regarding the use of confidential client information in connection with evaluating the adequacy of financial statement disclosures. Those commenters generally recognized the limited nature of AU sec. 431.04 and acknowledged that, since in 2003 the Board did not adopt Rule 301, removing a portion of the interim standards based on that rule was a conforming amendment. However, they were concerned that the Board's action might be construed as minimizing the auditor's responsibilities for maintaining the confidentiality of client information.

The Board is aware that many auditors have legal or professional obligations to maintain the confidentiality of client information. These requirements arise from the rules of state licensing authorities,[25] the rules of professional organizations such as the AICPA and the International Federation of Accountants, and the laws of some foreign jurisdictions. The Board's decision to omit Rule 301 from its interim standards was based on a determination that incorporation of that rule was not necessary to fulfill the Board's mandate under Section 103(a)(1) and (3) of the Sarbanes-Oxley Act. It did not reflect a decision that auditor confidentiality requirements imposed by other authorities were inappropriate. Similarly, in amending AU sec. 431, the Board seeks neither to modify nor to detract from existing confidentiality requirements.

Interpretations of the Auditing Standards in AU 400 Sections

The auditing interpretation in AU sec. 9420.52-.54 has been incorporated into Auditing Standard No. 6 and therefore has been eliminated, as proposed. The auditing interpretations in AU sec. 9411 and the remaining auditing interpretations in AU sec. 9420 are addressed by the accounting standards and therefore also have been eliminated as proposed.[26]

AU sec. 508, Reports on Audited Financial Statements

In general, the Board has adopted the amendments as proposed. The amendments have conformed this interim auditing standard to Auditing Standard No. 6 on evaluating consistency and the amendments to AU secs. 410 and 411, described above. For example, AU sec. 508.16 now specifically identifies the matters related to consistency of the company's financial statements that should be recognized in the auditor's report. Similarly, AU sec. 508.17A provides the requirements for evaluating consistency, that also is in paragraph 7 of Auditing Standard No. 6. AU secs. 508.17B and C, and AU sec. 508.18A provide separate requirements for reporting on changes in accounting principles and restatements, as discussed previously.

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[25] For example, confidentiality requirements are included in the provisions of the Uniform Accountancy Act, which has been enacted in some form by many states.

[26] One commenter suggested that some of the auditing interpretations should be retained because the guidance is still relevant. The Board considered the view of this commenter but decided to eliminate the interpretations because other auditing standards provided the necessary direction regarding the matter addressed in the interpretation, the interpretation dealt with items not requiring recognition in the auditor's report, or the interpretation was related to an accounting consideration of the company.

In addition, the amendments eliminate AU sec. 508.14-.15. Those paragraphs were an application of AICPA Ethics Rule 203, which, as previously noted, was not adopted as an interim standard by the Board.[27]

Finally, in light of the definitions in SFAS No. 154, the amendments change references to "restatements" to the more general term "adjustments" to refer broadly to changes to previously issued financial statements that may result from either a correction of a misstatement or a change in accounting principle.[28]

References to APB Opinion No. 20

In addition, the Board has adopted other amendments to update references to APB Opinion No. 20, which was superseded by SFAS No. 154. Accordingly the Board amended AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, footnote 3 to paragraph .06, to reference paragraphs 25 and 26 of SFAS No. 154. For AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, footnote 4 to paragraph .19, the Board referenced paragraph 20 of SFAS No. 157, *Fair Value Measurements*, which states that a change in valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. This replaces a reference to the preferability requirement in SFAS No. 157 because that requirement does not apply to a change in a company's method for determining fair value. Paragraph 20 is the accounting guidance applicable to a company's change in method for determining fair value.

E. Effective Date

This standard and amendments will be effective 60 days after approval by the SEC.

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On the 29th day of January, in the year 2008, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Secretary

January 29, 2008

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[27] One commenter expressed concern about deleting these paragraphs and suggested that, if the Board's intent was to delete all reference to the AICPA Code of Professional Conduct from the Board's interim standards, the Board should indicate the professional ethics that auditors should follow when conducting audits according to PCAOB standards. The Board's Rules 3500T and 3600T describe the Board's interim ethics and independence standards, respectively. These standards include certain provisions from the AICPA's Code of Professional Conduct. In addition, the Board has adopted ethics and independence rules concerning independence, tax services, and contingent fees. See PCAOB Release No. 2005-014 (July 26, 2005). State law and membership organizations may impose additional requirements.

[28] Some commenters suggested that certain other changes were needed to AU sec. 508 or that certain amendments were not necessary. For example, some commenters suggested eliminating AU sec. 508.57 and retaining the original terminology in AU secs. 508.73-.74. The Board decided that some of the suggested changes would change existing practice, such as the elimination of AU sec. 508.57, and were outside the scope of this project. For the others, the Board concluded that the amendments were consistent with the direction in Auditing Standard No. 6. In addition, one commenter believed that there were inconsistencies between the proposed amendments to AU sec. 508 and Staff Questions and Answers, *Adjustments to Prior-Period Financial Statements Audited By a Predecessor Auditor*. However, the Board reviewed the Staff Questions and Answers and did not agree that there were inconsistencies with the proposed amendments to AU sec. 508.

APPENDICES—

1. Auditing Standard No. 6—*Evaluating Consistency of Financial Statements*
2. Amendments to Interim Auditing Standards

Appendix 1

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

[Supersedes AU secs. 420 and 9420]

Consistency and the Auditor's Report on Financial Statements

1. This standard establishes requirements and provides direction for the auditor's evaluation of the consistency of the financial statements, including changes to previously issued financial statements, and the effect of that evaluation on the auditor's report on the financial statements.

2. To identify consistency matters that might affect the report, the auditor should evaluate whether the comparability of the financial statements between periods has been materially affected by changes in accounting principles or by material adjustments to previously issued financial statements for the relevant periods.

3. The periods covered in the auditor's evaluation of consistency depend on the periods covered by the auditor's report on the financial statements. When the auditor reports only on the current period, he or she should evaluate whether the current-period financial statements are consistent with those of the preceding period. When the auditor reports on two or more periods, he or she should evaluate consistency between such periods and the consistency of such periods with the period prior thereto if such prior period is presented with the financial statements being reported upon.[1] The auditor also should evaluate whether the financial statements for periods described in this paragraph are consistent with previously issued financial statements for the respective periods.[2]

> Note: The term "current period" means the most recent year, or period of less than one year, upon which the auditor is reporting.

4. The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:

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[1] For example, assume that a company presents comparative financial statements covering three years and has a change in auditors. In the first year in which the successor auditor reports, the successor auditor evaluates consistency between the year on which he or she reports and the immediately preceding year. In the second year in which the successor auditor reports, the successor auditor would evaluate consistency between the two years on which he or she reports and between those years and the earliest year presented.

[2] When a company uses retrospective application, as defined in Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("SFAS No. 154"), to account for a change in accounting principle, the financial statements presented generally will be consistent. However, the previous years' financial statements presented with the current year's financial statements will reflect the change in accounting principle and, therefore, will appear different from those previous years' financial statements on which the auditor previously reported. This standard clarifies that the auditor's evaluation of consistency should encompass previously issued financial statements for the relevant periods.

a. A change in accounting principle
b. An adjustment to correct a misstatement in previously issued financial statements.[3]

Change in Accounting Principle

5. A change in accounting principle is a change from one generally accepted accounting principle to another generally accepted accounting principle when (1) there are two or more generally accepted accounting principles that apply, or when (2) the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle.[4]

Note: A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of a misstatement.

6. The auditor should evaluate and report on a change in accounting estimate effected by a change in accounting principle like other changes in accounting principle.[5] In addition, the auditor should recognize a change in the reporting entity[6] by including an explanatory paragraph in the auditor's report, unless the change in reporting entity results from a transaction or event. A change in reporting entity that results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit does not require recognition in the auditor's report.

7. The auditor should evaluate a change in accounting principle to determine whether –

a. The newly adopted accounting principle is a generally accepted accounting principle,
b. The method of accounting for the effect of the change is in conformity with generally accepted accounting principles,
c. The disclosures related to the accounting change are adequate,[7] and
d. The company has justified that the alternative accounting principle is preferable.[8]

8. A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements. If the auditor concludes that the criteria in paragraph 7

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[3] The term "error," as used in SFAS No. 154, is equivalent to "misstatement," as used in the auditing standards.

[4] See SFAS No. 154, paragraph 2c.

[5] SFAS No. 154, paragraph 2e, defines a "change in accounting estimate effected by a change in accounting principle" as "a change in accounting estimate that is inseparable from the effect of a related change in accounting principle."

[6] "Change in reporting entity" is a change that results in financial statements that, in effect, are those of a different reporting entity. See SFAS No. 154, paragraph 2f.

[7] Newly issued accounting pronouncements usually set forth the method of accounting for the effects of a change in accounting principle and the related disclosures. SFAS No. 154 sets forth the method of accounting for the change and the related disclosures when there are no specific requirements in the new accounting pronouncement.

[8] The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. See SFAS No. 154, paragraph 14.

have been met, the auditor should add an explanatory paragraph to the auditor's report, as described in AU sec. 508, *Reports on Audited Financial Statements*. If those criteria are not met, the auditor should treat this accounting change as a departure from generally accepted accounting principles and address the matter as described in AU sec. 508.

Note: If a company's financial statements contain an investment accounted for by the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting principle that is material to the investing company's financial statements, the auditor should add an explanatory paragraph (following the opinion paragraph) to the auditor's report, as described in AU sec. 508.

Correction of a Material Misstatement in Previously Issued Financial Statements

9. The correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, as described in AU sec. 508.

10. The accounting pronouncements generally require certain disclosures relating to restatements to correct misstatements in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the inadequacy of disclosure as described in AU sec. 431, *Adequacy of Disclosure in Financial Statements*, and AU sec. 508.

Change in Classification

11. Changes in classification in previously issued financial statements do not require recognition in the auditor's report, unless the change represents the correction of a material misstatement or a change in accounting principle. Accordingly, the auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. For example, certain reclassifications in previously issued financial statements, such as reclassifications of debt from long-term to short-term or reclassifications of cash flows from the operating activities category to the financing activities category, might occur because those items were incorrectly classified in the previously issued financial statements. In such situations, the reclassification also is the correction of a misstatement. If the auditor determines that the reclassification is a change in accounting principle, he or she should address the matter as described in paragraphs 7 and 8 and AU sec. 508. If the auditor determines that the reclassification is a correction of a material misstatement in previously issued financial statements, he or she should address the matter as described in paragraphs 9 and 10 and AU sec. 508.

Appendix 2

Amendments to Interim Auditing Standards

The following amendments relate to the standards and auditing interpretations in AU sec. 328, the AU 400s sections, AU sec. 508, and AU sec. 561 of the Board's auditing standards.

Auditing Standards

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

Statement on Auditing Standards ("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. The text of footnote 4 to paragraph .19 is replaced with the following:

> Statement of Financial Accounting Standard No. 157, *Fair Value Measurements*, states that a change in valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances.

AU sec. 410, "Adherence to Generally Accepted Accounting Principles"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 410 (AU sec. 410, "Adherence to Generally Accepted Accounting Principles"), as amended, is amended as follows:

a. Paragraph .02 is replaced with following paragraph, and the reference to footnote 1 is moved to the end of the new paragraph .02.

The fourth standard of reporting is:

> The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

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. The third sentence of paragraph .01 is replaced with the following:

> The purpose of this section is to explain the meaning of "present fairly" as used in the phrase "present fairly . . . in conformity with generally accepted accounting principles." In applying this section, 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.

b. Paragraphs .02, .05, .07, and .09–.18 are deleted.

AU sec. 9411, "The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*, Auditing Interpretations of Section 411"

Auditing Interpretation No. 3, "The Auditor's Consideration of Management's Adoption of Accounting Principles for New Transactions or Events" of the auditing interpretations of AU sec. 411 (AU sec. 9411.11–.15) is deleted.

AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles," and AU sec. 9420, "Consistency of Application of Generally Accepted Accounting Principles, Auditing Interpretations of Section 420"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 420 (AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles"), as amended, and the related auditing interpretations (AU sec. 9420) are superseded by PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*.

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") is amended as follows:

a. Footnote 1 is deleted.

b. Paragraph .04 is deleted.

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 .03, footnote 2 is deleted.

b. In Paragraph .11, item .11b is deleted; item .11c is reordered as .11b; .11d is reordered as .11c; the paragraph references in .11c (formerly .11d) to paragraphs .16 through .18 are replaced with paragraph references .17A through .17E; and a new item .11d is added as follows:

> "A material misstatement in previously issued financial statements has been corrected (paragraphs .18A through .18C)."

c. Paragraphs .14–.15 are deleted, along with the preceding heading "Departure From a Promulgated Accounting Principle," and the note following the paragraph.

d. The text of paragraph .16 is replaced with the following:

> The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:
>
> a. A change in accounting principle
>
> b. An adjustment to correct a misstatement in previously issued financial statements

e. Paragraphs .17–.18 and related footnotes 12 and 13 are replaced with the following:

Change in Accounting Principle

.17A As discussed in PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, the auditor should evaluate a change in accounting principle to determine whether (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, (3) the disclosures related to the accounting change are adequate, and (4) the company has justified that the alternative accounting principle is preferable.[12] A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the opinion paragraph. If the auditor concludes that the criteria in this paragraph have been met, the explanatory paragraph in the auditor's report should include identification of the nature of the change and a reference to the note disclosure describing the change.

[12] The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. See FASB Statement 154, paragraph 14.

.17B Following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:

> As discussed in Note X to the financial statements, the company has changed its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].

.17C Following is an example of an explanatory paragraph when the company has made a change in accounting principle other than a change due to the adoption of a new accounting pronouncement.

As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*].

.17D The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.

.17E If the auditor concludes that the criteria in paragraph .17A for a change in accounting principle are not met, the auditor should consider the matter to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or adverse opinion.

Correction of a Material Misstatement in Previously Issued Financial Statements

.18A Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.[13] The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. Following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements.

As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.

[13] The directions in paragraphs .68-.69 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.

.18B This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.

.18C The accounting pronouncements generally require certain disclosures relating to restatements to correct a misstatement in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the lack of disclosure as discussed beginning at paragraph .41 and in AU sec. 431.

f. Paragraph .50 is deleted.

g. The text of paragraph .51 is replaced with the following:

Departures from generally accepted accounting principles related to changes in accounting principle. Paragraph .17A states the criteria for evaluating a

change in accounting principle. If the auditor concludes that the criteria have not been met, he or she should consider that circumstance to be a departure from generally accepted accounting principles and, if the effect of the accounting change is material, should issue a qualified or adverse opinion.

h. In paragraph .52:

- The first three sentences of the paragraph are replaced with the following:

  The accounting standards indicate that a company may make a change in accounting principle only if it justifies that the allowable alternative accounting principle is preferable. If the company does not provide reasonable justification that the alternative accounting principle is preferable, the auditor should consider the accounting change to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, should issue a qualified or adverse opinion. The following is an example of a report qualified because a company did not provide reasonable justification that an alternative accounting principle is preferable:

- In the second sentence of the first paragraph of the example report, the phrase "for making this change" is replaced with the phrase "that this accounting principle is preferable."

  In the text of footnote 17, the first two sentences are deleted; the word, "However" is deleted at the beginning of the third sentence; the word "because" at the beginning of the third sentence is capitalized; the phrase "the middle paragraph" is replaced with "this paragraph;" and the references to paragraphs ".16 through .18" are replaced with references to paragraphs "17A through 17E."

i. The text of paragraph .57 is replaced with the following:

   If the auditor issues a qualified or adverse opinion because the company has not justified that an allowable accounting principle adopted in an accounting change is preferable, as described in paragraph .52, the auditor should continue to express that opinion on the financial statements for the year of change as long as those financial statements are presented and reported on. However, the auditor's qualified or adverse opinion relates only to the accounting change and does not affect the status of a newly adopted principle as a generally accepted accounting principle. Accordingly, while expressing a qualified or adverse opinion for the year of change, the independent auditor's opinion regarding the subsequent years' statements need not express a qualified or adverse opinion on the use of the newly adopted principle in subsequent periods.

j. In the text of footnote 19 to paragraph .59, "(b)" is added to the beginning of the list of subsections.

k. The first sentence of footnote 20 to paragraph .62 is deleted.

l. In the second sentence of footnote 25 to paragraph .67, replace the phrase "section 420, *Consistency of Application of Generally Accepted Accounting Principles*," with the phrase "PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*"

m. In the second sentence of paragraph .69:

- Item (c) is inserted as follows:

  (c) if applicable, a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period,
- Item (c) is changed to (d)
- Item (e) is inserted as follows:

  (e) if applicable, a reference to the company's disclosure of the correction of the misstatement,
- Item (d) is changed to (f) and the words "the fact" are inserted at the beginning of the item

n. In the third sentence of paragraph .73, the word "restated" is replaced with the word "adjusted."

q. In paragraph .74:

- In the first sentence of the third text paragraph, the word "restated" is replaced with the word "adjusted," and the word "restatement" is replaced with the words "the adjustments."
- In the second sentence of the third text paragraph, the word "restatement" is deleted, and the word "his" is replaced with the words "the auditor's."

AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," section 561, "Subsequent Discovery of Facts Existing at the Date of Report," as amended, is amended as follows:

a. The text of footnote 3 to paragraph .06 is replaced with the following:

> See paragraphs 26 and 27 of Accounting Principles Board Opinion No. 9 and paragraphs 25 and 26 of FASB Statement No. 154, regarding disclosure of adjustments applicable to prior periods.

PCAOB Release No. 2008-003

Ethics and Independence Rule 3526, Communication With Audit Committees Concerning Independence, *Amendment to Interim Independence Standards, Amendment to Rule 3523,* Tax Services for Persons in Financial Reporting Oversight Roles, *Implementation Schedule for Rule 3523*

PCAOB Release No. 2008-003
April 22, 2008
PCAOB Rulemaking
Docket Matter No. 017

Summary: The Public Company Accounting Oversight Board ("PCAOB" or "Board") is adopting an ethics and independence rule, Rule 3526, *Communication with Audit Committees Concerning Independence,* that will supersede the Board's interim independence requirement, *Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees* ("ISB No. 1"), and two related interpretations. The Board is also adopting an amendment to Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles,* and further adjusting the implementation schedule for Rule 3523 as it applies to tax services provided during the audit period. Specifically, amended Rule 3523 will not prohibit tax services provided during the portion of the audit period that precedes the beginning of the professional engagement period. In order to maintain the status quo while the SEC considers this amendment, the Board has further delayed the implementation of the prohibition against pre-engagement period tax services to persons in financial reporting oversight roles in existing Rule 3523 until December 31, 2008. The amendment to Rule 3523 will become effective immediately upon approval by the SEC, and Rule 3526 will become effective on the later of September 30, 2008, or 30 days after the date the SEC approves the rule.

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I. Introduction

On July 26, 2005, the Public Company Accounting Oversight Board ("PCAOB" or "Board") adopted certain rules related to registered public accounting firms' provision of tax services to public company audit clients. As part of this rulemaking, the Board adopted Rule 3523, which provides that a registered firm, subject to certain exceptions, is not independent of an audit client if the firm, or an affiliate of the firm, provides tax services during the audit and professional engagement period to a person in, or an immediate family member of a

person in, a financial reporting oversight role ("FROR") at an audit client. Rule 3523 was intended to address concerns related to auditor independence when auditors provide personal tax services to individuals who play a direct role in preparing the financial statements of public company audit clients. Rule 3523 was approved by the Securities and Exchange Commission ("SEC" or "Commission") on April 19, 2006.

On April 3, 2007, the Board issued a concept release to solicit comment about the possible effects on a registered firm's independence of providing tax services to a person covered by Rule 3523 during the portion of the audit period that precedes the beginning of the professional engagement period and other practical consequences of applying the restrictions imposed by Rule 3523 to that portion of the audit period.[1] With a few exceptions, commenters on that release recommended that the Board amend Rule 3523 to exclude that portion of the audit period.

After considering the comments received, on July 24, 2007, the Board proposed to amend Rule 3523 as described in the concept release.[2] At the same time, the Board also proposed Rule 3526, *Communication with Audit Committees Concerning Independence*, a new ethics and independence rule that would supersede *Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees* ("ISB No. 1"), and two related interpretations, and require a registered public accounting firm to communicate certain information related to the firm's independence to the issuer's audit committee.

The Board received 16 comment letters on the proposed rules. Overall, the commenters were supportive of proposed Rule 3526 and the proposed amendment to Rule 3523. Commenters generally agreed that proposed Rule 3526 would enhance communication between the auditor and the audit committee and recommended that the Board adopt the rule. Commenters also reiterated that they believed that an auditor's independence would not be impaired by the provision of tax services to a person in a FROR during the portion of the audit period that precedes the beginning of the professional engagement period, and that the Board should adopt the proposed amendment to Rule 3523. Commenters also suggested certain modifications to the proposed rules.

The Board is adopting proposed Rule 3526 and the proposed amendment to Rule 3523 with some modifications in response to comments. This release describes key aspects of the amendment and new rule, comments received, and changes incorporated in the final rules. Additionally, as described below, the Board is further adjusting the implementation schedule for Rule 3523, as it applies to tax services provided to persons in FRORs during the period subject to audit but before the professional engagement period begins, to allow sufficient time for the SEC to consider whether to approve the amendment to the rule.

II. Rule 3526. Communication With Audit Committees Concerning Independence

Under Section 301 of the Sarbanes-Oxley Act of 2002 ("the Act"), "[t]he audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer...for

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[1] See PCAOB Release No. 2007-002 (April 3, 2007). Because the Board has adjusted the implementation schedule for Rule 3523, the rule has not prohibited the provision of tax services to persons in FRORs during the portion of the audit period that precedes the beginning of the professional engagement period.

[2] See PCAOB Release No. 2007-008 (July 24, 2007).

the purpose of preparing or issuing an audit report or related work...."[3] PCAOB interim independence standards require the auditor to provide certain information to the audit committee about independence that could assist the audit committee in fulfilling these oversight responsibilities. Specifically, ISB No. 1 requires, among other things, firms to disclose at least annually to the audit committee all relationships between the auditor and its related entities and the company and its related entities that, in the auditor's professional judgment, may reasonably be thought to bear on the auditor's independence. ISB No. 1 does not, however, require the firm to provide information to the audit committee about the firm's independence in connection with *becoming* the issuer's auditor (i.e., *before* the person or firm becomes the issuer's auditor).

As discussed in the proposing release, the Board proposed Rule 3526 because it believed that the accounting firm should discuss with the audit committee before accepting an initial engagement pursuant to the standards of the PCAOB any relationships the accounting firm has with the issuer that may reasonably be thought to bear on its independence. The proposed rule was intended to build on the communication requirements in ISB No. 1 and provide the audit committee with information—including information about the firm's relationships with persons in FRORs at the company—that may be important to its determination about whether to hire the firm as the company's auditor. The Board also proposed to include in the rule a new requirement for the firm to document the substance of its discussion with the audit committee.

All commenters were generally in favor of the Board adopting the proposed rule, and, as discussed more fully below, some recommended modifications. Commenters stated that Rule 3526 would assist audit committees in fulfilling their responsibilities and would aid them in their decision making process. After carefully considering the comments, the Board is adopting Rule 3526 with one modification, as described below. If approved by the SEC, Rule 3526 will supersede ISB No. 1 and two related interpretations.[4]

A. Scope of the Required Communication

The Board proposed in Rule 3526(a) to require the registered firm, prior to accepting an initial engagement pursuant to the standards of the PCAOB, to

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[3] The SEC has implemented this provision by adopting rules directing the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by the Act.

[4] ISB Interpretation 00-1, The Applicability of ISB Standard No. 1 When "Secondary Auditors" Are Involved in the Audit of a Registrant, and ISB Interpretation 00-2, *The Applicability of ISB Standard No. 1 When "Secondary Auditors" Are Involved in the Audit of a Registrant, An Amendment of Interpretation 00-1*. The interpretations state that the responsibility to comply with ISB No. 1 rests solely with the primary auditor, but that the primary auditor should include in its report to the audit committee all of its relationships and those of its domestic and foreign associated firms that could reasonably bear on the independence of the primary auditor. Under these interpretations, if the primary auditor is relying on the work of secondary auditors not associated with the primary auditor's firm, the report of the primary auditor should either describe any such secondary auditors' relationships, or it should state that it does not do so. The treatment of secondary auditors under Rule 3526 will be similar to the treatment of secondary auditors under ISB No. 1 and the two interpretations. Secondary auditors will not need to comply with Rule 3526, but the primary auditor will need to disclose to the audit committee any relationships of the firm's affiliates that could reasonably be thought to bear on the independence of the primary auditor. As under ISB No. 1 and the related interpretations, the scope of any communications about secondary auditors under Rule 3526 should be clear to the audit committee. Accordingly, the Board expects the primary auditor's report to either include any covered relationships of any secondary auditors not affiliated with the firm or state that it does not do so. One commenter recommended that the Board consider providing an exemption for secondary auditors. Because the rule does not require communications by secondary auditors, an exemption is not necessary.

describe in writing to the audit committee[5] all relationships between the accounting firm or any affiliates of the firm[6] and the potential audit client or persons in FRORs at the potential audit client that may reasonably be thought to bear on independence. The Board also proposed to require the firm to discuss with the audit committee the potential effects of those relationships on the firm's independence. In Rule 3526(b), the Board proposed to require a registered firm on at least an annual basis after becoming the issuer's auditor to provide the same information described above and also affirm to the audit committee of the issuer, in writing, that the firm is independent in compliance with Rule 3520, *Auditor Independence*.[7] As described in the proposing release, the Board intended for these communications to provide the audit committee with sufficient information to understand how a particular relationship might affect independence and to foster a robust discussion between the firm and the audit committee.

Commenters generally believed that the scope of the required communications was appropriate. Several commenters noted that, to a large extent, firms are already making the kinds of communications that would be required by proposed Rule 3526. One commenter acknowledged, however, that existing communications between the firm and a potential new audit client do not include the disclosure of tax services to a person in a FROR or his or her immediate family member. Additionally, some registered firms noted that communications regarding the auditor's independence currently vary in content and timing and may, in some instances, occur only orally.

Most commenters did not believe that it was necessary for the Board to expand the scope of the required communication to include any additional matters. One commenter, however, recommended requiring the firm to confirm its independence in writing to the audit committee prior to accepting an initial engagement. Another commenter recommended revising Rule 3526(a) to require the firm to make the communications in its initial proposal to the company's audit committee. As discussed above, the Board proposed to require firms to affirm their independence annually but did not propose a similar requirement that would apply before the firm is initially engaged as the company's auditor. Rule 3526(a) requires registered firms to make certain communications about relationships that may reasonably be thought to bear on independence before accepting an initial engagement pursuant to the standards of the PCAOB. Rather than prescribing a particular time before that point when the communications must occur, however, the rule allows registered firms and audit committees the flexibility to make that determination. The Board understands that, in some cases, firms need time before a new engagement begins to resolve any matters

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[5] One commenter recommended the Board provide guidance in situations in which an issuer does not have an audit committee. Under Section 2(a)(3) of the Act, "[t]he term 'audit committee' means – (A) a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and (B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer." Accordingly, under Rule 3526, if an audit client does not have an audit committee, the auditor would be required to make the communications to the entire board of directors.Additionally, one commenter recommended that audit committees provide better disclosure, through the proxy, when approving non-audit services performed by the auditor. The commenter stated that providing this type of transparency will permit investors a greater ability to evaluate audit committee's fiduciary performance of shareholders. The Board does not have statutory authority to require disclosure by audit committees.

[6] One commenter recommended that the Board adopt a definition of affiliate of the firm. This term is already defined in Rule 3501.

[7] Rule 3520 states that a registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period.

that could impair their independence. If a firm were required to affirm its independence prior to accepting a new engagement, it would need to wait until it has resolved any independence issues to make the required communications. These communications are intended to assist the audit committee in fulfilling its responsibility to hire the auditor—their usefulness for that purpose may diminish if they are left until immediately before the engagement begins. Accordingly, the Board does not believe a requirement for auditors to affirm that they are independent before accepting a new engagement is appropriate.

Other commenters recommended certain exclusions from the scope of the required communications. For example, one commenter asserted that the auditor cannot be expected to know about all relationships that may reasonably be thought to bear on its independence, and recommended that the written communication to the audit committee state that the auditor's assessment is based on information provided to the auditor by the issuer. The Board does not believe that allowing auditors to include such a limitation in the communication would be appropriate. Complying with the Board's independence requirements is the responsibility of the auditor.[8] To fulfill this responsibility, as well as their related responsibility under the SEC's independence rules, auditors need to ascertain what relationships with the issuer and persons in FRORs at the issuer may reasonably be thought to bear on their independence. Moreover, some of the information the auditor must assess in order to assure its independence and that may need to be communicated under Rule 3526—such as the firm's or its associated persons' financial interests in the audit client—can be more readily obtained by the auditor than its audit client.

Another commenter recommended that the Board exclude tax services to a person in a FROR from the required communications because the commenter believed that compliance with Rule 3523, as amended, should adequately address any independence concerns regarding such services. As discussed in the proposing release, Rule 3526 is intended to require disclosure of not only whether the firm provided any specifically prohibited services or maintained any specifically prohibited relationships, but also whether any of the firm's relationships or services may reasonably be thought to bear on independence under the SEC's general standard of auditor independence[9] and AU sec. 220, *Independence*.[10] Because auditors will need to consider the relevant facts and circumstances

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[8] Another commenter suggested that the audit committee should be able to rely on the firm to determine and resolve any independence issues, and that a requirement for the auditor to discuss these matters with the audit committee would increase the responsibilities of the audit committee with respect to independence. This commenter recommended that the Board not adopt these requirements. As discussed above, the rule is intended to provide audit committees with information to assist them in carrying out their responsibilities to oversee the audit engagement, but auditors remain responsible for complying with the independence requirements. Nothing in the rule adds to, or otherwise modifies, the responsibilities of the audit committee.

[9] 17 C.F.R. § 210.2-01(b). Under that standard, an accountant is not independent if "the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement." In considering this general standard, the SEC "looks in the first instance to whether a relationship or the provision of service: creates a mutual or conflicting interest between the accountant and the audit client; places the accountant in the position of auditing his or her own work; results in the accountant acting as management or an employee of the audit client; or places the accountant in a position of being an advocate for the audit client." 17 C.F.R. § 210.2-01, preliminary note.

[10] AU sec. 220, *Independence*, requires that "[i]n all matters relating to theassignment, an independence in mental attitude is to be maintained by the auditor..." AU sec. 220 notes that "[i]t is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors" and that public confidence in the auditor's independence "would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence."

in order to make such a determination, the Board does not believe that *per se* exemptions are appropriate.

Some commenters suggested that, in certain circumstances, firms would be restricted in the information they could provide to the audit committee about relationships with persons in FRORs due to legal limitations imposed by confidentiality and privacy laws. Specifically, one commenter was concerned that the auditor would not be able to disclose to the audit committee information about tax services rendered to a person in a FROR prior to obtaining a consent from that person. Another commenter recommended that the Board address the need for obtaining such a consent in its final release, while another recommended that the Board provide an exemption in circumstances where applicable legal restrictions impede an auditor's ability to comply fully with the disclosure requirement.

Under ISB No. 1, auditors have been required to disclose to the audit committee relationships with the company and its related entities and to discuss the auditor's independence with the audit committee. Accordingly, the required communications could include discussion of tax or other services provided to an entity or person other than the company itself. The Board understands that firms are subject to certain confidentiality requirements in the tax context[11] and that other restrictions could arise outside of that context, depending on the facts and circumstances that a particular relationship presents. The Board is not, however, aware that firms have encountered difficulty in communicating with audit committees, as required by ISB No. 1 or any other professional practice standard, as a result of such privacy requirements.

As described above, Rule 3526 is a general requirement that, like ISB No. 1, requires disclosure of certain relationships that may be relevant to the audit committee's oversight of the engagement. It does not set forth a list of relationships that must always be disclosed or mandate specific information that must be communicated when disclosure is required. Rather, Rule 3526 allows firms significant flexibility to determine how to comply with the requirements to describe a covered relationship and discuss the potential effects of that relationship on the firm's independence. Accordingly, while the Board will monitor the application of the rule in this regard, it does not believe that the recommended exception is necessary or appropriate at this time.

The Board also received several comments on its proposal not to include the words "in the auditor's professional judgment" in the rule's description of the scope of the required communications. ISB No. 1 requires disclosure of certain relationships that "in the auditor's professional judgment may reasonably be thought to bear on independence." In the proposing release, the Board explained that it believed that omitting the reference to the auditor's professional judgment would clarify the requirement by reminding auditors of the need to focus on the perceptions of reasonable third parties when making independence determinations. Some commenters supported the proposed exclusion of the words "in the auditor's professional judgment" from Rule 3526. Other commenters, however, believed that the absence of the reference to judgment could confuse, rather than clarify, the requirement and noted that it is reasonable and appropriate for audit committees to rely on the accounting firm's judgment as to what matters should be disclosed. One of these commenters contended that this aspect of the Board's proposal is inconsistent with the Board's recent

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[11] See 26 U.S.C. § 7216; 26 C.F.R. § 301.7216-3 (prohibiting disclosure or use of tax return information without written consent of taxpayer that meets specified requirements); 26 C.F.R. § 301.7216-1 (defining "tax return information" to mean "any information, including, but not limited to a taxpayer's name, address, or identifying number, which is furnished in any form or manner for, or in connection with, the preparation of a tax return of the taxpayer").

focus on the importance of the use of auditor judgment. Conversely, one commenter did not object to the absence of a reference to judgment, provided that the adopting release contain an acknowledgement that the auditor must apply judgment in determining which matters are required to be communicated to the audit committee.[12]

As the Board explained in the proposing release, auditors will need to apply judgment to determine whether a relationship may reasonably be thought to bear on independence. After considering commenters' views, the Board continues to believe that adding specific reference to the auditor's professional judgment is unnecessary and inappropriate in this instance. While the Board agrees that auditors must exercise sound judgment in carrying out their responsibilities, it does not believe that specific reference to judgment in this rule is necessary to encourage auditors to do so. Judgment is called for in applying any reasonableness standard to particular facts and circumstances, and Rule 3526 is no different. Determining what relationships may reasonably be thought to bear on independence requires consideration of how a third party—not the auditor—would view the relationship, which is consistent with the SEC's general standard of auditor independence and AU sec. 220. A reference to "in the auditor's professional judgment" could suggest otherwise, however, and therefore could discourage the necessary analysis. Accordingly, the Board has determined not to add the phrase to Rule 3526.

B. Time Period Covered by Rule 3526(a)

In the proposing release, the Board solicited comment on whether the initial communication in Rule 3526(a) should be limited to relationships that existed during a particular period, and, if so, how long that period should be. Commenters provided a wide variety of recommendations in this area. Some commenters stated that the initial communication should not be limited to relationships that existed during a particular period. Some of these commenters noted that establishing a specific period could result in arbitrary exclusion of certain relationships and recommended that the audit committee and auditor be responsible for determining the relevant time frame.

Other commenters recommended that the time period be limited to the audit and professional engagement period because, according to these commenters, the relevant relationships are those that exist currently or will continue to exist. One of these commenters stated that requiring communication of relationships that existed prior to this period would cause an unnecessary burden on the firm to identify and communicate these matters and on the audit committee to consider such information, because the firm was not subject to the auditor independence rules with respect to the audit client before the beginning of the audit and professional engagement period. One commenter recommended that the required time period should, at a minimum, be the audit period and that the rule should require auditors to consider communicating relationships that existed before that time. Finally, one commenter recommended that the time period should be no longer than two years prior to the commencement of the audit period, and two commenters recommended that the proposed rule should cover a time period of at least three years.

After considering these comments, the Board has determined that the initial communication required by Rule 3526(a) should not be limited to relationships

[12] Additionally, one commenter recommended including the reference to judgment and also referring to the SEC's general standard of auditor independence and the preliminary note to the SEC's independence rules in the proposed rule or the adopting release. Footnote 9 of this release refers to the general standard and the preliminary note.

that existed during a particular time period. While the Board agrees that a relationship that existed during the audit and professional engagement period may be more likely to bear on independence than a relationship that ended substantially before that time, it does not believe that the passage of time is the only factor relevant to a determination of whether a relationship may reasonably be thought to bear on independence. The nature of the relationship must also be considered. For example, if the firm customized and implemented the company's financial reporting system, that relationship, depending on the circumstances, might reasonably be thought to bear on independence even if the engagement to design the system was concluded before the beginning of the audit and professional engagement period. Determining whether a particular relationship is covered by Rule 3526(a) will, therefore, depend on the relevant facts and circumstances.

The Board is making one modification to the rule in response to a comment recommending that Rule 3526 make clear that the relationships required to be disclosed are those that may reasonably be thought to bear on independence as of the date of the communication. Because the relevant relationships are those that continue to bear on independence at the time of the communication, the Board has modified the rule by adding the words "as of the date of the communication" where appropriate. This clarification should help firms distinguish relationships that are covered by the rule from those that are not.

This modification should also clarify that, if a relationship may reasonably be thought to bear on independence as of the date of the communication, it must be disclosed regardless of whether it was disclosed in a prior year. Some commenters suggested that auditors should not be required to repeat a previously made disclosure. The Board believes that an earlier disclosure may reduce the amount of information that needs to be disclosed, but it does not obviate the need for disclosure altogether. If the nature of the relationship and the potential effects of the relationship on independence remain substantially unchanged, a reference to the earlier disclosure will generally be sufficient when disclosure is required. Moreover, as discussed above, after some amount of time, the length of which depends on the nature of the relationship, a relationship may no longer reasonably be thought to bear on independence and, therefore, would no longer need to be disclosed.

C. Timing of the Communications

As discussed above, the Board proposed Rule 3526(a) because it believed that auditors should communicate relevant information about independence before becoming the issuer's auditor. A few commenters expressed concern that the proposed rule could cause undue burden on private companies pursuing an initial public offering if the communication were required before the auditor accepts an engagement to assist an existing private company client in going public. According to commenters, a requirement to complete the independence assessment before the auditor could commence work related to the initial public offering might disadvantage the audit client by causing delay. One commenter stated that auditors generally begin work on the initial public offering based upon an initial review of relationships between the accounting firm and the company and complete their independence assessment before the company's registration statement is filed. This commenter suggested that the Board reconsider the required timing of the communications in the context of an initial public offering.

After considering these comments, the Board has determined that relieving a firm whose private company audit client is pursuing an initial public offering

from compliance with Rule 3526 is not necessary or appropriate. As discussed above, the rule is intended to provide audit committees with the information they need to effectively oversee the audit engagement. When a private company undertakes an initial public offering, it must, for the first time, have its financial statements audited by an auditor that is independent within the meaning of the rules of the SEC and PCAOB. Among other decisions an audit committee must make is whether to engage its existing auditor for the initial public offering or whether to retain a new auditor for that purpose. In this context, the Board believes that the communication about an existing auditor's independence—which is relevant to the existing auditor's ability to continue as the company's auditor through, and after, the initial public offering—should not be delayed until just before the registration statement is filed. Moreover, the Board believes that this evaluation will not cause an unnecessary burden because the private company is already a client of the accounting firm and therefore should already be aware of most of the relationships that would need to be communicated.

The Board also received comment on the timing of the annual communication requirement that the Board proposed in Rule 3526(b). Like ISB No. 1, proposed Rule 3526 did not specify when during the year the firm would be required to make the annual communication.[13] One commenter recommended that the Board specify in Rule 3526(b) when the annual communication should take place to make sure that these critical discussions do not take place at the end of the audit engagement. The commenter recommended that the proposed rule be changed to state that firms should apply Rule 3526 as early in the audit process as practicable, preferably during the planning stage of the audit. One commenter recommended that the communication occur before substantial planning procedures commence, while another recommended that the annual communication should take place at the time the engagement letter is signed and then again near the end of the audit. Finally, one commenter recommended adding a section to Rule 3526 requiring an auditor to update the communications when he or she becomes aware of a covered, previously unknown or new relationship.

After considering these comments, the Board does not believe it is appropriate to mandate specifically when the Rule 3526(b) annual communication take place. In most cases, the communications will be more useful if they take place near the beginning of the audit process. However, by not prescribing the timing of the communication, Rule 3526(b) will allow the auditor and audit committee to determine the timing that is most appropriate in the circumstances of the particular engagement. Similarly, the Board does not believe that it is necessary for the rule to explicitly address how a firm should correct an incomplete communication.

III. Rule 3523. Tax Services for Persons in Financial Reporting Oversight Roles

A. Amendment to Rule 3523 to Exclude the Portion of the Audit Period That Precedes the Professional Engagement Period

Rule 3523, as adopted by the Board, prohibits a registered public accounting firm, or an affiliate of the firm, from providing tax services during the "audit and professional engagement period" to a person in, or an immediate family

[13] The Board understands that, under ISB No. 1, the communication typically occurs at the end of the audit when the financial statements are issued.

member of a person in, a FROR at the audit client. Consistent with the SEC's independence rules,[14] the phrase "audit and professional engagement period" is defined to include two discrete periods of time. The "audit period" is the period covered by any financial statements being audited or reviewed.[15] The "professional engagement period" is the period beginning when the firm either signs the initial engagement letter or begins audit procedures, whichever is earlier, and ends when either the company or the firm notifies the SEC that the company is no longer that firm's audit client.[16]

In circumstances in which a registered firm has been the auditor for an audit client for more than a year, the "audit period" is a subset of the "professional engagement period." However, when a registered firm accepts a new audit client, the audit period may cover a period of time before the commencement of the professional engagement period. In such circumstances, Rule 3523, as adopted, provides that the firm is not independent of its audit client if the firm, or an affiliate of the firm, provided tax services to a person covered by Rule 3523 during the audit period but before the beginning of the professional engagement period. This aspect of the rule therefore effectively prevents a firm from accepting a new audit client if the firm, or an affiliate of the firm, provided tax services to such a person during the period covered by any financial statements to be audited or reviewed.

In preparing for implementation of the Board's tax services and independence rules, the Board decided to revisit the application of Rule 3523 to tax services provided during the audit period. As discussed above, on April 3, 2007, the Board issued a concept release to solicit comment about the possible effects on a firm's independence of providing tax services to a person covered by Rule 3523 during the portion of the audit period that precedes the beginning of the professional engagement period, and other practical consequences of applying the restrictions imposed by Rule 3523 to that portion of the audit period. After careful consideration of comments received in response to the concept release, the Board, on July 24, 2007, proposed to amend the rule to exclude the portion of the audit period that precedes the beginning of the professional engagement period.[17]

The Board received 13 comments on the proposed amendment to Rule 3523. Almost all of the commenters supported the Board's recommendation to amend Rule 3523.[18] Many of these commenters reiterated their belief that the firm's independence would not be affected by the provision of tax services to a person in a FROR during the portion of the audit period that precedes the beginning of the professional engagement period. Commenters also reaffirmed their belief

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[14] 17 C.F.R. § 210.2-01(f)(5).

[15] Rule 3501(a)(iii)(1).

[16] Rule 3501(a)(iii)(2).

[17] See PCAOB Release No. 2007-008, which includes a discussion of the comments the Board received on the concept release.

[18] Only one commenter on the proposed rule objected to the amendment of Rule 3523. This commenter's objection stemmed from the contention that the terms "professional engagement period" and "a person in a financial reporting role" were not defined. Definitions for "professional engagement period" and "financial reporting oversight role" are provided under Rules 3501(a)(iii)(2) and 3501(f)(i), respectively. The same commenter, while not specifically addressing the proposed amendment, also expressed concern with Rule 3523(a), which provides an exception for tax services to a person who is in a FROR only because he or she serves as a member of the Board of Directors, and, referring to the responsibilities of directors, recommended deleting this section in its entirety. This commenter also recommended that the Board eliminate Rule 3523, which provides an exception, under certain circumstances, for tax services to a person who is in a FROR only because of the person's relationship to an affiliate of the entity being audited. The Board does not believe that eliminating these exceptions is warranted.

that, if Rule 3523 is not amended, it could adversely affect companies' ability to change auditors by limiting the companies' choice of auditors.

The Board has carefully considered these comments, as well as the comments on the concept release,[19] and determined to adopt the amendment to Rule 3523. The Board continues to believe that it is not necessary for the rule to restrict the provision of tax services during the portion of the audit period that precedes the professional engagement period. Rule 3523 relates to services provided to individuals and not the audit client that issues the financial statements subject to audit. Additionally, registered firms would remain responsible for considering the relevant facts and circumstances of a specific tax engagement and determining whether their independence is impaired under the SEC's general standard of auditor independence.[20]

One commenter objected to the discussion in the proposing release (and included here in the paragraph above) describing the firm's obligation to consider whether the firm's independence is impaired under the SEC's general standard of auditor independence. This commenter stated that the discussion sends a contradictory message by calling for firms to assess whether their independence is impaired despite the Board's conclusion that restrictions are unnecessary to preserve independence. The Board disagrees. As a result of the Board's amendment, firms will not be specifically prohibited by Rule 3523 from providing tax services to persons in a FROR during the portion of the audit period that precedes the professional engagement period. That does not mean, however, that such services are categorically permitted. Rather, as discussed in the proposing release, the amendment reflects the Board's belief that a more tailored approach, based on facts and circumstances and measured against the general standard of auditor independence, is preferable to a *per se* prohibition. Accordingly, as with any other service or relationship that is not specifically prohibited by the independence rules, firms must determine whether the service or relationship impairs independence under the SEC's general standard of auditor independence.

B. Application of Rule 3523 to New Issuers

The Board proposed adding a note to Rule 3523 concerning the application of Rule 3523 in the context of an initial public offering in light of comments received on the concept release. The proposed note stated that, in the context of an initial public offering, the provision of tax services to a person covered by Rule 3523 before the earlier of the date that a registered firm: (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB, or (2) began procedures to do so, does not impair a firm's independence under Rule 3523. Commenters generally recommended that the Board adopt the note and encouraged the Board to consider expanding it to include other corporate life events, noting that corporate life events other than an initial public offering may also result in the need for an audit client's

[19] In response to the concept release, two commenters stated that Rule 3523 should not be amended to exclude the portion of the audit period that precedes the professional engagement period. These commenters believed that providing tax services to a person in a FROR during the audit period impairs independence, and suggested that audit firms may plan for a change of auditors sufficiently in advance to avoid or minimize any problems resulting from the application of the rule to the audit period.

[20] 17 C.F.R. § 210.2-01(b); see footnote 9.

financial statements to be audited pursuant to the standards of the PCAOB for the first time.[21]

In response to these comments, the Board determined to revise the note to Rule 3523 to describe events, other than just initial public offerings, pursuant to which a company's financial statements must be audited in accordance with the standards of the PCAOB for the first time. Specifically, the Board replaced the words "[i]n the context of an initial public offering" with "[i]n an engagement for an audit client whose financial statements for the first time will be required to be audited pursuant to the standards of the PCAOB." This situation may occur when a company decides to conduct an initial public offering of its securities,[22] which would require the company to file, for the first time, a registration statement under the Securities Act of 1933. Additionally this situation may occur when a foreign private issuer decides to list its securities on a national securities exchange, which would require the company to register its securities, for the first time, under the Securities Exchange Act of 1934. In both cases, the company's audited financial statements would be required, for the first time, to be audited pursuant to the standards of the PCAOB.[23]

The Board does not believe it is appropriate to list in the note the various corporate life events identified by commenters, such as mergers or acquisitions, reverse mergers or other similar transactions. The relevant factor is not the name given to a transaction or event but whether the transaction or event triggers the initial requirement for an audit pursuant to the standards of the PCAOB. For example, the surviving company in a merger or acquisition transaction may be an issuer that is already filing with the SEC financial statements required to be audited pursuant to the standards of the PCAOB. The Board did not intend the note to Rule 3523 to describe such a scenario.[24] By focusing on the need for a first-time audit pursuant to the standards of the PCAOB, the company and its auditors are better able to determine whether a proposed transaction or corporate life event is described by the note.

One commenter stated that, while it is easy to identify the date on which the initial engagement letter to perform an audit pursuant to the standards of the PCAOB is signed, it would be very difficult to apply the second prong of the note, which requires identification of the date that the auditor began procedures to perform an audit pursuant to the standards of the PCAOB, especially

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[21] Commenters suggested the following as examples of when an audit client's financial statements would, for the first time, need to be audited pursuant to the standards of the PCAOB—mergers, reverse mergers in which a privately-held entity merges with a public company and succeeds to the public company's reporting obligations under the Securities Exchange Act of 1934, issuance of publicly traded debt, issuance of partnership or other units, inclusion of a public company's securities in an employee benefit plan, decision by a foreign private issuer to list its securities in the United States, and companies that have greater than 500 U.S. shareholders and total assets exceeding $10 million as of the latest fiscal year-end.

[22] The company may offer equity securities, debt securities, limited partnership interests, trust interests, or another type of securities in the initial public offering.

[23] The Board intends the note to Rule 3523 to describe all circumstances in which a company that was not an "issuer," as defined by the Act, becomes an issuer as a result of a corporate life event or otherwise. These circumstances include those in which a private company that was once an issuer becomes an issuer again. As long as the company was not required to have its financial statements audited pursuant to the standards of the PCAOB, the company and its auditors are better able to determine whether a proposed transaction or corporate life event is described by the note.

[24] Another example is a private operating company becoming a reporting company through a reverse merger with a reporting shell company. In this scenario, even though the operating company assumes the reporting obligations of the former shell company, the surviving reporting company is the former shell company whose financial statements already were required to be audited pursuant to the standards of the PCAOB. Therefore, the note to Rule 3523 does not describe this situation.

if the registered firm audited the company's prior years' financial statements.[25] Another commenter similarly questioned whether this period begins when the auditor begins planning for the audit. The Board recognizes that, in certain circumstances, it may be difficult to identify when a continuing auditor began procedures pursuant to the standards of the PCAOB. An auditor begins procedures for purposes of Rule 3523 when he or she begins procedures, including required audit planning procedures, to update its earlier audits to conform them to the standards of the PCAOB or begins procedures on a new audit pursuant to those standards. This point in time will depend on the facts and circumstances of the particular engagement and corporate life event, rather than on any more specific triggering event that the Board could establish by rule.

C. Transition Periods

Rule 3523 prohibits the provision of tax services to covered persons once the professional engagement period begins. Some commenters on the concept release recommended that the Board amend Rule 3523 to allow a transition period after a company changes auditors so that the new auditor may complete any tax services in progress to any persons in FRORs affected by the issuer's change of auditors.[26] Other commenters stated that tax services to persons in FRORs should, as is currently required, cease before the professional engagement period begins. The Board decided to seek further feedback on this topic in the proposing release. Specifically, the Board asked commenters to specify why they believed any transition period was necessary and how long any such transition period should be.[27]

The majority of commenters on this topic recommended that the Board provide for a 180-day transition period to allow an accounting firm to complete covered tax services once the professional engagement period begins. Most of these commenters stated that, since the Board has previously determined that a 180-day transition is appropriate when a person is hired or promoted into a FROR,[28] the Board should provide the same transition when an issuer changes its auditor. The commenters stated that, without a transition period, the person in a FROR could experience undue hardship because he or she may have to switch tax preparers in the middle of the personal tax services engagement. Additionally, some commenters stated that some accounting firms may not be able to terminate the in-process personal tax services engagements within a timeframe that would also allow them to submit their proposal for the new audit engagement. Conversely, some commenters stated that they believed that the Board should not provide a transition period and that it is appropriate for the firm to cease the personal tax services before the professional engagement

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[25] The commenter noted that, when a company undertakes an initial public offering, it is required to include in the registration statement audited financial statements for its past three completed fiscal years. These financial statements may have previously been audited pursuant to generally accepted auditing standards ("GAAS"). The commenter was concerned that if the company does not retain a new auditor for its initial public offering, there may be a question as to whether the auditor should consider its audits of the prior years in assessing when it "began procedures" as provided under the note to Rule 3523. An auditor should not consider work already performed on previously completed GAAS audits for determining when the auditor "began procedures" because those audits were not performed pursuant to the standards of the PCAOB.

[26] Rule 3523(c) provides a time-limited transition period for an auditor to complete in-progress tax services to a person that becomes a FROR at the audit client through a hiring, promotion, or other change in employment event. That transition period is unaffected by this release.

[27] See PCAOB Release 2007-008 (July 24, 2007), at 12.

[28] See Rule 3523(c).

period begins or that a transition period should only be available on a case-by-case basis where cessation of services would cause significant hardship.[29]

After considering these comments, the Board does not believe that a transition period is necessary when a company changes its auditor and has determined not to amend Rule 3523 to include one. The Board adopted Rule 3523 because the provision of tax services to a person in a FROR after the accounting firm is hired as the auditor creates an unacceptable appearance that the firm lacks independence. While the Board believed a time-limited exception was warranted to accommodate persons who, through a hiring or promotion event, abruptly become covered by the rule, it does not believe that such a transition period is similarly necessary after an auditor change. In the former situation, the firm already is the issuer's auditor and has no control over whether or when the person is promoted or otherwise moved into a FROR. In contrast, the firm controls whether and when it begins a new engagement. The Board therefore believes that the firm is able to conclude, or transition to another provider, any tax services to persons in FRORs at a new audit client before beginning the engagement.[30]

Some commenters also encouraged the Board to consider providing a transition period for firms to complete tax services to persons who become covered by Rule 3523 as a result of a corporate life event, such as a merger, acquisition, or initial public offering. Commenters suggested that such corporate life events present conceptually similar transition issues to those related to the hiring or promotion of a person into a FROR and that Rule 3523(c) should therefore be expanded to accommodate them. Commenters also stated that the absence of transitional relief may cause unnecessary hardship for persons in FRORs whose tax return preparation work was well underway at the point of the initial public offering, merger, or acquisition.[31]

As discussed above, in the context of an initial public offering, the rule, as amended, makes clear that tax services provided to a person in a FROR do not impair independence as long as those tax services are concluded before the earlier of the date that the firm: (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB, or (2) began procedures to do so. Auditors should have sufficient time before that date to conclude any tax services to persons that would be covered by the rule. Accordingly, the Board does not believe that the recommended transition period is necessary in the context of an initial public offering.

The Board also considered whether a transition period is necessary to allow a firm to conclude tax services to persons who become covered by the rule after a merger or acquisition. As discussed above, Rule 3523 already provides a transition period for a firm to conclude tax services to a person who was not in a FROR before a hiring, promotion, or other change in employment event. If a

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[29] Another commenter stated that Rule 3523 should be effective immediately for issuers with fiscal years ending on or after December 15, 2007, that all personal tax services in process should be allowed to continue until the filing of the applicable tax return, and that such services, along with the related fees, should be disclosed in the issuer's filings with the SEC and documented in the minutes of meetings of the audit committee.

[30] Nothing in Rule 3523 requires a firm to complete or terminate tax services to persons in FRORs at a potential audit client before submitting a proposal for a new audit engagement. Rather, the rule requires the accounting firm to complete or terminate those services by the beginning of the professional engagement period.

[31] The commenters further stated that, because persons in FRORs may receive tax services from a number of accounting firms, the application of the rule to the audit period may unreasonably restrict a company's ability to either continue or change auditors after a corporate life event. As discussed above, the Board has amended the rule to exclude the portion of the audit period that precedes the professional engagement period.

business combination results in a change of employer for a person in a FROR—from, for example, the acquired company to the acquiring company—the existing transition period in Rule 3523 would apply.[32] For example, if Company A acquires Company B, a person who was in a FROR at Company B would experience an "other change in employment event" if he or she became an employee of Company A in a FROR as a result of the acquisition. If such a person had been receiving tax services from Company A's registered public accounting firm pursuant to an engagement in process before the acquisition, the time-limited exception in Rule 3523(c) would apply.[33]

In the example above, persons in FRORs at Company A would not experience a change in employment event because they were employed by Company A both before and after the acquisition, and Rule 3523(c) would, therefore, not apply. If Company B's auditor became Company A's auditor after the acquisition (replacing Company A's auditor), Company B's auditor would have to conclude any tax services to persons in FRORs (and their immediate family members) at Company A before the start of the professional engagement period. The Board believes this is appropriate because, as discussed above, the Board does not believe that a transition period is necessary to allow a newly engaged auditor to conclude in-progress tax services to persons in FRORs at the new audit client. Accordingly, the Board has determined not to expand the existing transition period in Rule 3523(c).

IV. Effective Date and Adjustment of Implementation Schedule

Rule 3526 establishes new requirements for registered public accounting firms. The Board believes it is appropriate to allow a reasonable period of time for such firms to prepare internal policies and procedures and train their employees to ensure compliance with these new requirements. Accordingly, Rule 3526 will become effective, and ISB No. 1 and the related interpretations superseded, on the later of September 30, 2008, or 30 days after the date that the SEC approves the rule.

The amendment to Rule 3523 would have the effect of making permanent the Board's delay in implementing the rule as it applies to tax services provided during the period subject to audit but before the professional engagement period. Accordingly, no transition period is necessary, and the amended rule will become effective immediately upon approval by the SEC. The Board has also determined to further adjust the implementation schedule for Rule 3523 to allow sufficient time for the SEC to consider whether to approve the amendment to Rule 3523.[34] Specifically, the Board will not apply Rule 3523 to tax services provided on or before December 31, 2008, when those services are provided during the audit period and are completed before the professional engagement period begins.[35] The Board has filed this adjustment to the implementation schedule with the SEC as an immediately effective proposed rule change. The

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[32] See also Staff Questions and Answers, *Ethics and Independence Rules Concerning Independence, Tax Services and Contingent Fees* (April 3, 2007), Question and Answer No. 6, at 4-5.

[33] Id.

[34] Under the adjustment to the implementation schedule for Rule 3523 that the Board made on July 24, 2007, the Board will not apply Rule 3523 to tax services provided on or before April 30, 2008, when those services are provided during the audit period and are completed before the professional engagement period begins.

[35] This will apply regardless of whether there is an engagement in process on April 30, 2008.

rule change became effective upon its filing with the SEC, thereby extending to December 31, 2008 the implementation date for this aspect of Rule 3523.

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On the 22nd day of April, in the year 2008, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
J. Gordon Seymour
Secretary
April 22, 2008

APPENDICES—

1. Amendment to Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*
2. Ethics and Independence Rule 3526, *Communication with Audit Committees Concerning Independence*
3. Amendment to the PCAOB Interim Independence Standards

Appendix 1

Amendment to Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*

The relevant portion of the Rule, as amended, is set out below. Language deleted by this amendment is struck through. Language that is added is underlined.

RULES OF THE BOARD

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SECTION 3. PROFESSIONAL STANDARDS

* * *

Part 5—Ethics

* * *

Subpart I—Independence

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Rule 3523. Tax Services for Persons in Financial Reporting Oversight Roles

A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the ~~audit and~~ professional engagement period provides any tax service to a person in a financial reporting oversight role at the audit client, or an immediate family member of such person, unless—

a. the person is in a financial reporting oversight role at the audit client only because he or she serves as a member of the board of directors or similar management or governing body of the audit client;

b. the person is in a financial reporting oversight role at the audit client only because of the person's relationship to an affiliate of the entity being audited—

(1) whose financial statements are not material to the consolidated financial statements of the entity being audited; or

(2) whose financial statements are audited by an auditor other than the firm or an associated person of the firm; or

c. the person was not in a financial reporting oversight role at the audit client before a hiring, promotion, or other change in employment event and the tax services are—

(1) provided pursuant to an engagement in process before the hiring, promotion, or other change in employment event; and

(2) completed on or before 180 days after the hiring or promotion event.

Note: In an engagement for an audit client whose financial statements for the first time will be required to be audited pursuant to the standards of the PCAOB, the provision of tax services to a person covered by Rule 3523 before the earlier of

the date that the firm: (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB, or (2) began procedures to do so, does not impair a registered public accounting firm's independence under Rule 3523.

Appendix 2

Ethics and Independence Rule 3526, *Communication With Audit Committees Concerning Independence*

RULES OF THE BOARD

* * *

SECTION 3. PROFESSIONAL STANDARDS

* * *

Part 5—Ethics

* * *

Subpart I—Independence

* * *

Rule 3526. Communication with Audit Committees Concerning Independence

A registered public accounting firm must—

a. prior to accepting an initial engagement pursuant to the standards of the PCAOB—

(1) describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence;

(2) discuss with the audit committee of the issuer the potential effects of the relationships described in subsection (a)(1) on the independence of the registered public accounting firm, should it be appointed the issuer's auditor; and

(3) document the substance of its discussion with the audit committee of the issuer.

b. at least annually with respect to each of its issuer audit clients—

(1) describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the audit client or persons in financial reporting oversight roles at the audit client that, as of the date of the communication, may reasonably be thought to bear on independence;

(2) discuss with the audit committee of the issuer the potential effects of the relationships described in subsection (b)(1) on the independence of the registered public accounting firm;

(3) affirm to the audit committee of the issuer, in writing, that, as of the date of the communication, the registered public accounting firm is independent in compliance with Rule 3520; and

(4) document the substance of its discussion with the audit committee of the issuer.

Appendix 3

Amendment to PCAOB Interim Independence Standards

Independence Standards Board Standard No. 1*, Independence Discussions with Audit Committees* ("ISB Standard No. 1"), ISB Interpretation 00-1, *The Applicability of ISB Standard No. 1 When "Secondary Auditors" Are Involved in the Audit of a Registrant*, and ISB Interpretation 00-2, *The Applicability of ISB Standard No. 1 When "Secondary Auditors" Are Involved in the Audit of a Registrant, An Amendment of Interpretation 00-1*, are superseded by Rule 3526.

PCAOB Release No. 2009-004

Auditing Standard No. 7, Engagement Quality Review, *and Conforming Amendment to the Boards Interim Quality Control Standards*

PCAOB Release No. 2009-004
July 28, 2009
PCAOB Rulemaking
Docket Matter No. 025

Summary

After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") is adopting an auditing standard, *Engagement Quality Review*, that will be applicable to all registered firms and will supersede the Board's interim concurring partner review requirement, and a conforming amendment to the Board's interim quality control standards.

Board Contacts

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I. Introduction

Section 103 of the Sarbanes-Oxley Act (the "Act") directs the Board, among other things, to set standards for public company audits, including a requirement or each registered public accounting firm to "provide a concurring or second partner review and approval of [each] audit report (and other related information), and concurring approval in its issuance . . . ." A well-performed engagement quality review ("EQR") can serve as an important safeguard against erroneous or insufficiently supported audit opinions and, accordingly, can contribute to audit quality. In February 2008, the Board proposed to replace its interim requirement with a new EQR standard.[1] The Board's original proposal was developed in response, among other things, to feedback from some members of its Standing Advisory Group ("SAG") that the existing interim requirements[2]

[1] PCAOB Release No. 2008-002, Proposed Auditing Standard—*Engagement Quality Review and Conforming Amendment to the Board's Interim Quality Control Standards* (February 26, 2008) (the "original proposal").

[2] The Securities and Exchange Commission Practice Section ("SECPS") of the American Institute of Certified Public Accountants ("AICPA") Requirements of Membership Sections 1000.08(f); 1000.39, Appendix E.

(the "existing requirements") do not provide for a sufficiently thorough review to give investors assurance on the quality of engagements. The proposal was intended to enhance the quality of the EQR by strengthening the existing requirements.

Commenters recommended significant modifications to the original proposal, and, in response, the Board made changes designed to better tailor the standard to its purposes.[3] Because of the extent of those changes, the Board again sought public comment, this time on the standard as revised. The Board has considered those comments, as well as the input of the SAG, and the final standard ("AS No. 7" or the "EQR standard") has benefitted from the additional public input.[4]

The EQR standard the Board is adopting provides for a rigorous review that will serve as a meaningful check on the work performed by the engagement team. AS No. 7 should increase the likelihood that a registered public accounting firm will catch any significant engagement deficiencies before it issues its audit report. As a result, the Board recognizes that more work may be necessary under the EQR standard than was performed in some concurring reviews under the existing requirements.

At the same time, the Board has been sensitive to commenters' concerns and agrees that the EQR should not become, in effect, a second audit. Instead, the EQR should be—and, as described in AS No. 7, is—a review of work already performed by the engagement team. The EQR standard requires the engagement quality reviewer (or the "reviewer") to evaluate the significant judgments made and related conclusions reached by the engagement team in forming the overall conclusion on the engagement and in preparing the engagement report, and requires certain procedures designed to focus the reviewer on those judgments and conclusions.

The procedures required of the reviewer by AS No. 7 are different in nature from the procedures required of the engagement team. Unlike the engagement team, a reviewer does not perform substantive procedures or obtain sufficient evidence to support an opinion on the financial statements or internal control over financial reporting. If more audit work is necessary before the reviewer may provide concurring approval of issuance, the engagement team—not the reviewer—is responsible under PCAOB standards for performing the work. In contrast, the reviewer fulfills his or her responsibility to perform an effective review of the engagement under the EQR standard by holding discussions with the engagement team, reviewing documentation, and determining whether he or she can provide concurring approval of issuance.

II. Overview of Auditing Standard No. 7

Overall, commenters preferred the reproposed standard to the original proposal, though some continued to believe that certain provisions were unclear and suggested certain changes to the standard. After considering commenters' feedback, the Board has made several modifications to the EQR standard to

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[3] Comments on the original proposal and the Board's responses are described in PCAOB Release No. 2009-001, Proposed Auditing Standard—*Engagement Quality Review* (March 4, 2009) (the "reproposing release").

[4] The Board received 38 comments on the original proposal and 30 comments on the reproposal. The SAG discussed the reproposed standard on April 2, 2009. A transcript of that discussion is available on the Board's website at http://pcaobus.org/Rules/Rulemaking/Docket%20025/2009-04-02_EQR_SAG_Transcript.pdf. The SAG also discussed EQR on June 22, 2004 and October 5, 2005. Archived webcasts are available on the Board's website at http://pcaobus.org/News/Webcasts/Pages/default.aspx.

provide additional clarity. This section describes the comments received, the Board's response, and changes made in AS No. 7.[5]

A. Applicability of the EQR Requirement

Paragraph 1 of the reproposed standard required an EQR for audit engagements and reviews of interim financial information ("interim reviews"), but not for other engagements performed according to the standards of the PCAOB. For the most part, commenters believed that this provision was appropriate.[6] One commenter, however, suggested including the EQR requirements for interim reviews in AU section ("sec.") 722, *Interim Financial Information*, instead of including them as part of the EQR standard to "make it clear that the scope of the procedures performed remain under the umbrella of the objective of a review of interim financial information (which is much different than the scope and objective of an audit)." Because the requirements for the EQR of interim reviews in AS No. 7 are closely related to and described by reference to the requirements for the EQR of an audit, the Board believes it is more appropriate to locate both sets of requirements in the same standard. Accordingly, the Board is adopting the provisions regarding applicability of the EQR standard as reproposed.

B. Statement of Objective

The reproposed standard included a statement of objective intended to focus reviewers on the overall purpose of the standard as they carry out the more specific EQR requirements. As reproposed, the objective of the engagement quality reviewer was "to perform an evaluation of the significant judgments made by the engagement team and the conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report, if a report is to be issued, in order to determine whether to provide concurring approval of issuance."

Most commenters agreed that the EQR standard should include a statement of objective. While some believed the objective was appropriate as reproposed, several suggested substituting the phrase "related conclusions reached" for "the conclusions reached" to indicate that the reviewer is required to evaluate conclusions relating to significant judgments, rather than all conclusions. In addition, some commenters suggested making the objective less vague, while others wanted the Board to broaden it or make it less procedural.

After considering these comments, the Board has, as suggested by commenters, revised the objective so that it refers to "significant judgments made by the engagement team[7] and the *related* conclusions reached . . . ." (emphasis added). This change should help reviewers maintain their focus on areas of the engagement that are most likely to contain a significant engagement deficiency. With

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[5] The Board received some comments related to its standard-setting process in general. The Board continuously endeavors to improve its processes, including its standard-setting process, and is considering these comments as it does so.

[6] One commenter did not believe that an EQR should be required for interim reviews because of concerns about the scope of the EQR for interim reviews. The section entitled *Specifically Required Procedures in the EQR of an Interim Review* of this release discusses the EQR requirements for interim reviews.

[7] Because the engagement partner has final responsibility for the engagement, he or she has final responsibility for the significant judgments made during the engagement, notwithstanding any involvement in or responsibility for those judgments by firm personnel outside of the engagement team, such as members of the firm's national office. Accordingly the "significant judgments made by the engagement team" include all of the significant judgments made during the engagement.

this revision, the Board believes the statement of objective establishes, at the appropriate level of detail, a framework for the performance of the EQR that is consistent with the specific requirements in AS No. 7. Corresponding changes have been made in paragraphs 9 and 14, which describe the scope of the EQR for audits and interim reviews, respectively. The reviewer achieves his or her objective by complying with the specific requirements of the standard.

C. Qualifications of the Engagement Quality Reviewer

In order to provide for a high-quality EQR, the reproposed standard described the qualifications that any reviewer would be required to meet. These provisions were designed to provide assurance that the reviewer could effectively perform an EQR of the particular engagement under review. At the same time, the provisions recognized that smaller firms may have few partners—and, in the case of sole practitioners, no additional partners—available in-house to perform the EQR.

Accordingly, the reproposed standard required an engagement quality reviewer from within the firm issuing the engagement report to be a partner or another individual in an equivalent position, but also allowed a qualified individual from outside the firm to perform the EQR. In either event, the reproposed standard required the reviewer to be an associated person[8] of a registered public accounting firm.[9] The reproposed standard also included a general competence requirement and requirements related to the reviewer's independence, integrity, and objectivity.

In-House Reviewer: Partner or an Individual in an Equivalent Position

The requirement in the reproposed standard for a reviewer from within the firm to be a partner or an individual in an equivalent position was intended to address concerns expressed by some commenters on the original proposal about the authority of the engagement quality reviewer relative to that of the engagement partner. Because the EQR is intended to be an objective second look at work performed by the engagement team, the reviewer should be able to withstand pressure from the engagement partner or other firm personnel, such as members of the firm's national office. As described in the reproposing release, the Board believed that concerns about authority will most often arise when the reviewer and the engagement partner work at the same firm. The Board also believed that a standard based on perceptions of relative authority within a firm would not be sufficiently clear to be workable. Accordingly, the Board attempted to address these concerns with a requirement that an in-house reviewer—but not one from outside the firm—be a partner or person in an equivalent position.

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[8] For clarity, in paragraph 3 of AS No. 7, the Board added a reference to Rule1001(p)(i), which defines the term "associated person of a registered public accounting firm." A person not already associated with a registered firm can enter into a relationship with the firm issuing the report such that the person would become associated with that firm by performing the review. Specifically, a person not already associated with a firm would become associated with the firm issuing the report if *he or she* (rather than, or in addition to, his or her firm or other employer): (1) receives compensation from the firm issuing the report for performing the review or (2) performs the review as agent for the firm issuing the report. For example, if the firm issuing the report contracts directly with an employee of an unregistered accounting firm to perform the engagement quality review, that person would become associated with the firm issuing the report by virtue of that independent contractor relationship.

[9] A registered public accounting firm has an obligation to secure and enforce consents to cooperate with the Board from each associated person of the firm, see Section 102(b)(3) of the Act, including those who become associated with the firm by performing the review. The Board also may directly sanction any such person who fails to cooperate in an investigation or inspection. See Section 105(b)(3) of the Act and PCAOB Rules 5110 and 4006.

While some commenters supported the reproposed requirement, others disagreed with it, generally because, in their view, being a partner or person in an equivalent position would not necessarily ensure that the reviewer possesses the qualities required to perform the EQR. These commenters noted that partners as well as non-partners may be subject to internal pressure within the firm to provide concurring approval of issuance. In addition, in one commenter's view, it would be burdensome for one-partner firms to hire an outside reviewer to comply with this requirement. Finally, some commenters also asked the Board to define the term "equivalent position."

While both partners and non-partners may experience pressure within the firm to provide concurring approval of issuance, the Board continues to believe that the reproposed requirement is the most appropriate way to address this issue. Partnership is not a perfect proxy for authority, but a partner is more likely to possess sufficient authority to conduct the EQR than a non-partner. The Board continues to believe that a requirement based on perceptions of authority would not be workable. Accordingly, the Board is adopting this requirement substantially as reproposed.[10] At a firm that is not organized as a partnership, "an individual in an equivalent position" is someone with the degree of authority and responsibility of a partner in a firm that is organized as a partnership.

Qualified Reviewer from Outside the Firm

As noted above, the reproposed standard also allowed a qualified reviewer from outside the firm to conduct the review. In the reproposing release, the Board expressed the view that allowing a sufficiently qualified professor or other individual not employed by an accounting firm to perform the EQR should not negatively affect audit quality and may mitigate the compliance burden on sole practitioners and smaller firms. The Board sought comment on whether a qualified accountant who is not employed by an accounting firm should be allowed to conduct the EQR.[11]

The majority of commenters on this topic did not oppose the reproposed provision. Some commenters, however, cautioned that reviewers from outside an accounting firm may not necessarily have the required technical expertise or recent audit experience. One commenter believed that allowing the use of such outside reviewers could "hamper the existing independence rules,"[12] increase costs, and limit the potential growth of partners.

After considering these comments, the Board continues to believe that the EQR standard can—and should—allow firms the proposed flexibility in choosing a reviewer, provided that reviewer meets the competence and other qualification requirements. According to these requirements, as discussed below, any reviewer would have to have the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the person who has overall responsibility for the engagement under review. Accordingly, while some persons from outside a firm might not have the required qualifications, those who do can effectively perform the EQR.[13]

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[10] One commenter suggested that the phrasing of the reproposed standard did not establish a requirement for the in-house reviewer to be a partner because it stated that the reviewer "may be" a partner, a person in an equivalent position, or an individual outside the firm. While the use of "may" in that context imposed a requirement, to avoid any confusion on this point the Board has rephrased the requirement in paragraph 3 of AS No. 7 to use the word "must."

[11] As noted in the reproposing release, under the existing requirement a firm may seek a waiver to engage an outside experienced individual to perform the EQR. Because AS No. 7 allows a firm to use an outside reviewer, such a waiver is not necessary under AS No. 7.

[12] The comment did not explain how the independence rules would be hampered.

[13] Similarly, a reviewer does not meet all of the qualification requirements in AS No. 7 by virtue of his or her status as a partner or employee of an accounting firm.

The Board also does not agree that allowing the use of a reviewer from outside the firm issuing the report would negatively affect the application or enforcement of the independence rules. As the Board noted in the reproposing release, it will continue to consider anyone who performs the EQR to be an "audit partner" and a member of the "audit engagement team" for purposes of independence requirements.[14] In addition, because AS No. 7 would not require a firm to use an outside reviewer, allowing a firm to do so should not increase costs or limit the potential growth of partners. Any firm that is concerned that invoking the flexibility provided by the EQR standard would raise its costs or impede the development of its partners could, simply, decline to do so and use a reviewer from within the firm if one is available.

When considering an outside individual for the role of the engagement quality reviewer, the firm will likely need to make additional inquiries to obtain necessary information about the individual's qualifications. For example, while information about independence of the firm's partners is typically collected and evaluated as part of the periodic independence review, information about the independence of an outside reviewer will likely need to be requested and evaluated as part of the reviewer selection process. Firms also likely know more about the competence of their own partners than of an outside reviewer.

General Competence Requirement

As noted above, the reproposed standard, like the original proposal, included a requirement for the reviewer to "possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the person who has overall responsibility for the same type of engagement." This provision was intended to set a minimum requirement for those who would perform the EQR. In response to comments on the original proposal, the reproposing release explained that this provision, by its terms, did not require the engagement quality reviewer's knowledge and competence to match those of the engagement partner, or for the reviewer to be a "clone" of the engagement partner.[15]

Some commenters reiterated their concerns that the engagement quality reviewer's skills would be expected to match those of the engagement partner, and that such a requirement could cause resource constraints for smaller firms. Other commenters suggested modifying the general competence provision by stating that the reviewer's competence should be established based on the facts and circumstances of the engagement, or describing the required qualifications from the reviewer's perspective, rather than by comparing them to the qualifications of the engagement partner. Finally, some commenters suggested including in the EQR standard a statement that the reviewer may obtain the required level of knowledge and competence through utilizing assistants.

The Board continues to believe that if a minimum level of knowledge and competence in accounting, auditing, and financial reporting is required to conduct an audit, it is similarly necessary to effectively review that audit.[16] The reviewer is

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[14] See Rule 2-01(f) of Regulation S-X, 17 C.F.R. 210.2-01(f), for the definitions of "audit partner" and "audit engagement team."

[15] Specifically, the reproposing release noted:

> The general competence provision merely sets a minimum requirement for those who would perform the EQR, but it does not require the reviewer's competence to match that of the engagement partner. In many cases, both individuals' competence will exceed the minimum level prescribed, but there is no requirement that they do so in tandem, or even at all.

[16] While a reviewer may use assistants in performing the EQR, the reviewer's own skills should meet the requirements of AS No. 7.

not required to possess other competencies, e.g., those related to communication or management skills, that the engagement partner may have.

Accordingly, the Board is adopting the general competence provision substantially as proposed. The Board is, however, modifying the requirement to clarify further that the determination of what constitutes the appropriate level of knowledge and competence should be based on the circumstances of the engagement, including the size and complexity of the business under audit or under interim review.[17] In AS No. 7, the Board replaced the phrase "the same type of engagement" with "the engagement." The new phrasing focuses the reviewer on the particular engagement under review, rather than that "type" of engagement.[18] Firms that do not have partners that meet this general competence requirement available to perform the EQR may engage an outside reviewer to perform an EQR.

Independence, Integrity, and Objectivity

Like the original proposal, the reproposed standard required the reviewer to be independent of the company, perform the review with integrity, and maintain objectivity. Comments on the reproposal focused on two provisions regarding objectivity—the prohibition against the reviewer supervising the engagement team and the two-year "cooling-off" period before the engagement partner could perform the EQR.

Supervision of the Engagement Team

The reproposed standard provided that to maintain objectivity the engagement quality reviewer should not, among other things, "supervise the engagement team with respect to the engagement subject to the engagement quality review." The phrase "subject to the engagement quality review" was intended to clarify that partners with leadership responsibilities in a firm, region, service, or industry practice are not, solely because of those responsibilities, precluded from reviewing any engagement performed by their subordinates in the firm. Some commenters believed that the phrase "subject to the engagement quality review" was not sufficient to clarify this point.

After considering these comments, the Board has decided that the express prohibition against "supervis[ing] the engagement team with respect to the engagement subject to the engagement quality review" is not necessary to effectuate the Board's intent. The remaining two criteria for maintaining objectivity in paragraph 7 of AS No. 7—not making decisions on behalf of the engagement team and not assuming any responsibilities of the engagement team—are sufficient to preclude those involved in the engagement from serving as the engagement quality reviewer.[19] For example, partners (including the engagement

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[17] Footnote 18 on page 9 of the original release stated, "The determination of what constitutes the appropriate level of knowledge and competence should be based on the circumstances of the engagement, including the size or complexity of the business."

[18] In addition, to simplify the text of AS No. 7, the Board replaced the phrase "person with overall responsibility for the engagement" with the term "engagement partner." Footnote 3 of AS No. 7 explains that the term "engagement partner" has the same meaning as the phrases the "auditor with final responsibility for the audit," as described in AU sec. 311, *Planning and Supervision*, and the "practitioner-in-charge of an engagement," as described 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*. Because all of these terms refer to the same person, this change does not alter the meaning of the EQR standard.

[19] AS No. 7 does not prohibit the engagement team from consulting with the reviewer, as long as the reviewer maintains his or her objectivity in accordance with paragraph 7. As noted in the reproposing release, such consultations may contribute to audit quality. In addition, one commenter

(continued)

partner and other partners on larger engagements), managers, and others who supervise engagement personnel on the audit under review would not qualify under the remaining criteria because they have assumed responsibilities of the engagement team. At the same time, removing the phrase "supervise the engagement team" from AS No. 7 should further clarify that those in leadership positions in the firm who did not make decisions for or assume responsibilities of the engagement team may perform the EQR.

The Two-Year "Cooling-Off" Period

The reproposed standard included a provision prohibiting an engagement partner from serving as the engagement quality reviewer for at least two years following his or her last year as the engagement partner.[20] The Board included the "cooling-off" period because it believed that it would be harder for an engagement partner who has had overall responsibility for the audit for at least a year to perform the review with the necessary level of objectivity. While a number of commenters expressed general support for a two-year "cooling-off" period, some believed that it could impose an undue hardship on smaller firms, and suggested a shorter "cooling-off" period.

After considering these comments, the Board continues to believe that a "cooling-off" period will be beneficial to audit quality and that a two-year period appropriately safeguards objectivity without imposing unnecessary hardship on most firms. At the same time, the Board recognizes that compliance with this requirement could be difficult for smaller firms with fewer personnel. In its independence rules, the Securities and Exchange Commission ("SEC") exempted certain smaller firms from the audit partner rotation requirements. Specifically, Rule 2-01(c)(6)(ii) of Regulation S-X provides an exemption for firms with fewer than five issuer audit clients and fewer than ten partners, provided the Board "conducts a review at least once every three years of each of the audit client engagements that would result in a lack of auditor independence under" the SEC partner rotation requirements. The Board believes that this exemption—including the provision regarding Board inspections—also describes an appropriate exemption from the "cooling-off" requirement in the EQR standard. Accordingly, firms that qualify for the exemption from the SEC partner rotation requirements will also be exempt from the "cooling-off" period under AS No. 7.

D. EQR Process

The Board's goal in proposing an EQR standard was to strengthen the existing requirements for concurring reviews in order to promote a more meaningful review of the work performed by the engagement team. Accordingly, the original proposal described certain procedures that the reviewer was required to

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(footnote continued)

asked the Board to clarify whether a reviewer may consult with the same personnel who previously consulted with the engagement team. The EQR standard does not prohibit the reviewer from holding discussions with such personnel. The reviewer may not, however, use personnel who previously consulted with the engagement team as assistants in performing the review unless they meet the objectivity and other qualification requirements of AS No. 7. To emphasize the requirement that assistants maintain objectivity, the Board added to paragraph 7 of AS No. 7 the phrase "and others who assist the reviewer."

[20] SEC independence rules allow engagement partners and concurring partners to serve for five consecutive years, after which they may not serve in either role for another period of five years. Within a five-year period, SEC independence rules do not impose a "cooling-off" period before the engagement partner can serve as the concurring partner. See Rule 2 - 01(c)(6)(i)(A) of Regulation S-X.

perform that were more specific than those in the existing requirements. In response to comments received on the original proposal, the Board clarified some of the specifically required procedures and included, in a separate section in the reproposed standard, tailored requirements for an EQR of an interim review.

In general, commenters believed that the reproposed standard described the requirements of the EQR more clearly than the original proposal. However, a number of commenters suggested additional modifications that, in their view, would further clarify the Board's intent and ensure consistency of the requirements with the statement of objective. As described below, after considering these comments, the Board has modified certain of these requirements.

Terminology Used to Describe the Required Procedures

Several commenters noted that the specifically required procedures in paragraphs 9, 10, 14, and 15 of the reproposed standard were described using different, but in some cases similar, terms such as "determine," "evaluate," "identify," "read," and "review," which some commenters found confusing. In one commenter's view, the terms "determine," "identify," and "evaluate" may require the reviewer to perform procedures that are similar in scope to the procedures performed by the engagement partner. The commenters asked the Board to clarify the terminology in these sections of the EQR standard.

While the Board does not believe that this terminology required the reviewer to perform procedures that are appropriately performed by the engagement partner, it does agree that the terminology should not be confusing. Accordingly, the Board reduced the number of terms used in AS No. 7, so that the required procedures in paragraphs 9, 10, 14, and 15 are described using two terms, "evaluate" and "review"—with one exception. Because AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, requires the auditor to *read* other information in documents containing the financial statements to be filed with the SEC, paragraphs 10.g and 15.e of AS No. 7, like in the original and reproposed standards, also require the reviewer to *read* such other information and evaluate whether the engagement team has taken appropriate action with respect to any material inconsistencies with the financial statements or interim financial information, respectively, or material misstatements of fact of which the engagement quality reviewer is aware.

Review of Documentation

A number of commenters viewed the statement in paragraphs 9 and 14 of the reproposed standard that "the reviewer should perform the procedures . . . by reviewing documentation" as too open-ended.[21] Commenters were concerned that this provision could be interpreted to require the review of all of the engagement documentation.

The Board did not intend to require—and the reproposed provision did not require—the reviewer to review all of the engagement documentation. Nevertheless, to clarify this point, the Board has added the phrase "to the extent necessary to satisfy the requirements" of paragraphs 10 and 11, in an EQR of an audit, and 15 and 16, in an EQR of an interim review. As a practical matter, the reviewer cannot comply with the requirements of the EQR standard without holding discussions with the engagement partner and reviewing documentation. AS No. 7 requires the reviewer to hold sufficient discussions with the engagement partner and other members of the engagement team and

[21] That statement was intended, along with other changes in the reproposed standard, to clarify that the EQR is a review of the engagement team's work rather than a second audit. See page 17 of the reproposing release.

review sufficient documentation to perform the required procedures with due professional care. What is sufficient will necessarily depend on the facts and circumstances of the particular engagement under review. Auditors often document their significant judgments and conclusions in various summary documents, which could serve as a starting point for the reviewer's evaluation of the engagement team's work.

Paragraph 11 of the reproposed standard required the reviewer, in an EQR of an audit, to evaluate whether the engagement documentation that he or she reviewed when performing the procedures required by paragraph 10 indicates that the engagement team responded appropriately to significant risks and supports the conclusions reached by the engagement team with respect to the matters reviewed. One commenter suggested adding a requirement to paragraph 11 to evaluate engagement documentation for compliance with the requirements of Auditing Standard No. 3, *Audit Documentation* ("AS No. 3"). The Board originally proposed such a requirement but, in response to comments, did not include it in the reproposed standard.[22] The Board continues to believe that the documentation review requirements of paragraph 11 of the reproposed standard are appropriate and is adopting them as reproposed.

In an EQR of an interim review, paragraph 16 of the reproposed standard required the reviewer to evaluate whether the engagement documentation that he or she reviewed "[i]ndicates that the engagement team responded appropriately to significant risks," and "[s]upports the conclusions reached by the engagement team with respect to the matters reviewed." Some commenters noted that the auditor is not required to identify significant risks in a review of interim financial information and suggested not including a corresponding requirement in the EQR standard. The Board agrees and has not included this requirement in AS No. 7.

Specifically Required Procedures in the EQR of an Audit

Like the original proposal, the reproposed standard required certain procedures designed to give the reviewer the necessary information to evaluate the engagement team's significant judgments and conclusions. In response to comments on the original proposal, the Board made changes to these provisions in the reproposed standard that were intended to clarify that the reviewer performs the EQR by reviewing the engagement team's work, rather than by auditing the company himself or herself. Some commenters suggested that the specifically required procedures in the reproposed standard needed additional clarification.

In the view of several commenters, the reproposed standard did not clearly articulate the requirement for the reviewer to focus on the significant judgments made and the related conclusions reached by the engagement team. These commenters believed that the reproposed standard might be interpreted as requiring the review of all of the engagement team's judgments and conclusions. In response, AS No. 7 refers to "significant judgments" instead of "judgments" in describing certain of the required procedures.

The Board also clarified the wording of paragraph 10.b of the reproposed standard, which required the reviewer to "evaluate the risk assessments and audit responses . . . ." Some commenters expressed concern that this formulation required a review of audit responses for all areas of the audit. In response, AS No. 7 more specifically requires the reviewer to evaluate the engagement team's audit responses to significant risks identified by the engagement team and other significant risks identified by the engagement quality reviewer through

[22] Commenters suggested that such a requirement would duplicate the documentation review performed by the engagement partner.

performance of the procedures required by the EQR standard.[23] This change should help focus reviewers on areas of the audit that are more likely to contain a significant engagement deficiency.

Some commenters also expressed concern about the requirements in paragraphs 10.e and 10.f of the reproposed standard to determine whether appropriate matters have been communicated to the audit committee, management, and others; and to determine whether appropriate consultations have taken place on difficult or contentious matters. According to these commenters, a requirement to determine whether all of the communications or consultations have taken place rather than to evaluate the engagement team's communications and consultations was inconsistent with the objective of the EQR. In response, the Board replaced the phrase "determine if" with "based on the procedures required by this standard, evaluate whether." This change should tailor the specific requirements more closely to the overall objective. The Board also placed these paragraphs after the other required procedures in paragraph 10 to emphasize that the reviewer performs the evaluation required by these paragraphs based on the information obtained through the other procedures required by the EQR standard, and made a corresponding change in paragraph 15 for the EQR of an interim review.

Specifically Required Procedures in the EQR of an Interim Review

In response to comments on the original proposal, the Board included in the reproposed standard separate requirements for reviewing audits and interim reviews. The EQR requirements for interim reviews were based on the requirements for an EQR of an audit but were tailored to the different procedures performed in an interim review. A number of commenters were supportive of including separate requirements for the EQR of interim reviews in the reproposed standard. Some commenters, as discussed below, suggested modifications to those requirements.

Paragraph 15.a of the reproposed standard required the evaluation of engagement planning, including the consideration of the firm's recent engagement experience with the company and risks identified in connection with the firm's client acceptance and retention process; the company's business, recent significant activities, and related financial reporting issues and risks; and the nature of identified risks of material misstatement due to fraud. In one commenter's view, that paragraph might suggest that an interim review should include the same type of risk assessment as an audit. After considering this comment, the Board disagrees. Paragraph 15.a does not impose a requirement on the engagement team to identify risks as part of an interim review. Rather, it requires the reviewer to evaluate the engagement team's consideration of risks that have already been identified, e.g., during the preceding year's audit.

Additionally, three commenters recommended not requiring the EQR of an interim review to include an evaluation of judgments made about the severity and disposition of identified control deficiencies. In one commenter's view, such

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[23] The term "significant risk" is defined in the Board's recently proposed auditing standard on identifying and assessing risks of material misstatement to mean a "risk of material misstatement that is important enough to require special audit consideration." PCAOB Release No. 2008-006, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards* (October 21, 2008). The Board intends that definition to apply to the EQR standard as well. The Board included this definition in a note to paragraph 10.b of AS No. 7. If, at the conclusion of the above mentioned rulemaking, the Board adopts a definition of significant risk that is different from that proposed, the Board will make a conforming change to the EQR standard.

an evaluation would be inconsistent with the scope of an interim review. AU sec. 722.07, provides that the auditor:

> should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302 of the Act.

In response, the Board modified the requirement in paragraph 15.b in AS No. 7 to be more consistent with the requirements of AU sec. 722. Accordingly, AS No. 7 requires the reviewer, among other things, to evaluate significant judgments made about any material modifications that should be made to the disclosures about changes in internal control over financial reporting.

Paragraph 15.c of the reproposed standard required the reviewer, in the EQR of an interim review, to "[r]ead the interim financial information for all periods presented and for the immediately preceding interim period, management's disclosure for the period under review, if any, about changes in internal control over financial reporting, and the related engagement report, if a report is to be filed with the SEC." Some commenters suggested that the reviewer should be required to read the engagement report even when the issuer is not required to include the report in an SEC filing. The Board agrees and, accordingly, changed "to be filed with the SEC" to "to be issued."[24]

E. Concurring Approval of Issuance

For an EQR of an audit, paragraph 12 of the reproposed standard provided that the reviewer "may provide concurring approval of issuance only if, after performing with due professional care the review required by this standard, he or she is not aware of a significant engagement deficiency." A note to the same paragraph describes a "significant engagement deficiency" as any of the four conditions described in the original proposal.[25] The reproposed requirements for providing concurring approval of issuance in an EQR of an interim review were the same, except that the first of these four conditions was modified in light of the differences between an interim review and an audit. Specifically, in an EQR of an interim review, the first condition was "the engagement team failed to perform interim review procedures necessary in the circumstances of the engagement" rather than "the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB."

Commenters generally believed that the concurring approval of issuance provision was appropriately described, though one recommended excluding the

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[24] Additionally, one commenter recommended not requiring the reviewer to read interim financial information "for the immediately preceding interim period" because it was not clear, to this commenter, what one would review when performing the EQR for the first quarter. AU sec. 722.16 requires the accountant to apply analytical procedures to the interim financial information, which should include, among other things, comparing the quarterly interim financial information with comparable information for the immediately preceding interim period (i.e., the fourth quarter of the prior year, in a first quarter interim review). Because the Board believes the reproposed requirement is appropriately within the scope of an EQR for an interim review, it has retained it in AS No. 7.

[25] As included in the reproposed standard, these conditions were: (1) the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB; (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement; (3) the engagement report is not appropriate in the circumstances; or (4) the firm is not independent of its client.

reference to "due professional care" from the EQR standard because AU sec. 230, *Due Professional Care in the Performance of Work*, already imposes an overall requirement on auditors to exercise due professional care. Many commenters, however, were critical of the reproposing release's description of the reproposed requirement. A significant number of commenters objected to, or stated that they disagreed with, the statement in the reproposing release that the requirement to exercise due professional care imposes on the engagement quality reviewer essentially the same requirement as the "knows, or should know based on the requirements of this standard" formulation that was originally proposed. Some suggested that the Board is redefining the meaning of due professional care. One commenter stated that "[a] standard of 'knows, or should know' is akin to a strict liability requirement for engagement deficiencies," while another commenter suggested that the Board "clarify that in this context, 'due professional care' is not a negligence standard."

After considering the comments, the Board is adopting the concurring approval of issuance requirement as reproposed. While auditors are already required to exercise due professional care in discharging their responsibilities, comments, as noted above and in the reproposing release, have reflected some confusion about the applicable standard of care in an EQR. Accordingly, reference to due professional care in the requirement is appropriate.

The Board is not redefining due professional care in the context of the EQR standard. As the Board noted in the reproposing release, AU sec. 230 describes due professional care as "reasonable care and diligence" and makes clear that an auditor who acts negligently, i.e., without "reasonable care and diligence," breaches the duty to exercise due professional care.[26] Due professional care, as described in AU sec. 230, imposes neither a strict liability nor an actual knowledge standard. The Board intends the term to mean "reasonable care and diligence," as described in AU sec. 230.

The application of a negligence standard to the concurring approval of issuance provision means, as noted in the reproposing release, that "a reviewer cannot evade responsibility because, as a result of an inadequate review, he or she did not discover a problem that a reasonably careful and diligent review would have revealed."[27] For that reason, the provision requires the reviewer to perform the required review with due professional care as a prerequisite to providing concurring approval of issuance. A qualified reviewer who has done so will, necessarily, have discovered any significant engagement deficiencies that could reasonably have been discovered under the circumstances. Accordingly, under AS No. 7, such a reviewer may provide concurring approval of issuance if "he or she is not aware of a significant engagement deficiency." Because a reviewer who has not performed the required review with due professional care might not have discovered any significant engagement deficiencies that could reasonably have been discovered under the circumstance—si.e., those the reviewer reasonably should know about—such a reviewer may not, consistent with the standard, provide concurring approval of issuance.

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[26] See AU sec. 230.03.

[27] Of course, to impose the more severe sanctions authorized under the Act, such as a permanent bar or permanent revocation of registration, the Board must establish "(A) intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard; or (B) repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard." Section 105(c)(5) of the Act; see also Rules on Investigations and Adjudications, PCAOB Release No. 2003-015, Appendix 2 at A2-76 (September 29, 2003) (discussing Section 105(c)(5)).

F. Documentation of the EQR

The reproposed standard required the EQR documentation to contain sufficient information to identify: who performed the review, the documents reviewed, whether and when concurring approval of issuance was provided or the reasons for not providing the approval, and the significant discussions held, including the details of such discussions. These provisions were intended to respond to comments expressing concern that the originally proposed documentation requirements were overly detailed and would result in duplication of the engagement team's work. Some commenters reiterated their concerns that some of the reproposed requirements were duplicative of requirements to document the engagement itself or overly burdensome.

The Board continues to believe that it is necessary to strengthen the documentation requirements in the interim standard to provide for an informative record of the work performed during the EQR. At the same time, the Board has reconsidered its approach to the documentation requirement in light of the comments received. As described below, the Board has added a general requirement that places the specific requirements in the context of the overall purpose of EQR documentation—to provide a record of how the reviewer carried out the review in accordance with the standard's requirements.

Specifically, paragraph 19 of AS No. 7 includes a requirement for the engagement documentation to contain sufficient information to enable an experienced auditor,[28] having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of the standard.[29] This provision is similar to the audit documentation requirement in paragraph 6 of AS No. 3, and should clarify how the more specific requirements are meant to apply in particular circumstances.

For example, if a reviewer identified a significant engagement deficiency to be addressed by the engagement team, the engagement team should document its response to the identified deficiency in accordance with AS No. 3. Because AS No. 7 does not require duplication of documentation prepared by the engagement team, the engagement quality reviewer does not have to separately document the engagement teams response. Rather, the EQR documentation should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand, e.g., the significant deficiency identified, how the reviewer communicated the deficiency to the engagement team, why such matter was important, and how the reviewer evaluated the engagement team's response. Similarly, if the reviewer participated in the discussion of the potential for material misstatement due to fraud,[30] and the engagement team documented the discussion in accordance with AS No. 3, AS No. 7 only requires the engagement quality reviewer or reviewer's assistants to prepare separate documentation if the documentation prepared by the engagement team does not contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of AS No. 7.

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[28] As described in paragraph 6 of AS No. 3, "[a]n experienced auditor has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry."

[29] Additionally, for clarity of presentation, the Board moved the requirement to include documentation of an EQR in the engagement documentation from paragraph 19 to a new paragraph 20 in AS No. 7.

[30] See paragraph .14 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

In response to comments, the Board also considered whether modifications were necessary to the specific requirements. First, the Board received several comments related to the provisions of reproposed paragraph 19.b, which required the EQR documentation to contain information sufficient to identify the documents reviewed. One commenter believed that a reviewer "may feel compelled to engage in an unnecessary review of additional documents in order to compile a more 'complete' list." Conversely, another commenter believed that the reviewer would be discouraged "to inspect one or more documents than he or she otherwise might or should, thus reducing the quality of the EQR." Some commenters suggested clarifying how the documents should be identified as "reviewed" (i.e., electronically or manually), or suggested limiting the scope of paragraph 19.b to "significant documents."

After considering these comments, the Board has decided to include this requirement in AS No. 7. Identifying a document as reviewed by the engagement quality reviewer should not be unduly burdensome, and will provide an informative record. Such a record could provide registered firms, and the Board, with better information about the EQR, which can be used to evaluate and improve the EQR process. The Board believes it is unnecessary to require in the standard a particular document identification method, such as electronic or manual signature. Rather, this should be determined by each firm individually.

Second, a number of commenters believed that the requirement in paragraph 19.c to document details of significant discussions held by the reviewer, and others who assisted the reviewer, would not improve audit quality and that it would be costly to implement. These commenters suggested that the reviewer might not be able to determine whether a discussion is significant at the time a discussion is held and therefore feel compelled to document every discussion. In order to make clear that documentation of every discussion is neither required nor a prudent use of resources, the Board has not included an explicit requirement to document discussions in AS No. 7. As explained above, however, if documentation of a particular discussion is necessary "to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed . . . to comply with the provisions of th[e] standard," such documentation is required under the general documentation requirement.

G. Effective Date

In reproposing the standard, the Board intended to make a final standard effective for EQRs of interim reviews for fiscal years beginning after December 15, 2009 and for EQRs of audits for fiscal years ending on or after December 15, 2009. Several commenters were concerned that the proposed effective date would not allow for sufficient time to train the auditing firm's personnel and implement the new EQR requirements. These commenters recommended that the effective date of the EQR standard be linked to the beginning of an audit period to provide adequate time for registered firms to prepare for adoption. The Board agrees with the concerns expressed by the commenters and has decided to make AS No. 7 effective, subject to SEC approval, for both the EQR of audits and the EQR of interim reviews for fiscal years beginning on or after December 15, 2009.

H. Comparison with other EQR Standards

Three commenters suggested that the Board provide a comparison between the EQR standard and standards of other standard-setters on this subject. One

commenter noted that because issuer clients often represent a minor part of a smaller firm's audit client base, the audit methodology of such a firm may be based on other standards as well as PCAOB standards. In response, the Board has described certain significant differences between the Board's EQR standard and the analogous standards of the International Auditing and Assurance Standards Board ("IAASB")[31] and the Auditing Standards Board ("ASB") of the AICPA[32] in Appendix 3. Each section of the appendix also includes references to the relevant paragraphs of AS No. 7.

Appendix 3 is provided for informational purposes only. It describes only certain provisions of AS No. 7, and is not a substitute for the EQR standard itself. The full text of AS No. 7 is included in Appendix 1 of this release. Compliance with AS No. 7 is required for registered public accounting firms. Compliance with the analogous ASB and IAASB standards is not sufficient to meet the requirements of AS No. 7.

* * *

On the 28th day of July, in the year 2009, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Secretary
July 28, 2009

APPENDICES—

1. Auditing Standard No. 7—*Engagement Quality Review*
2. Conforming Amendment to PCAOB Interim Quality Control Standards
3. *Analysis of Significant Differences between the Requirements of Auditing Standard No. 7*, Engagement Quality Review, *of the Public Company Accounting Oversight Board and the Analogous Standards of the International Auditing and Assurance Standards Board, and the Auditing Standards Board of the American Institute of Certified Public Accountants*

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[31] International Standard on Quality Control 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, and International Standard on Auditing 220, *Quality Control for an Audit of Financial Statements*, issued in December 2008.

[32] AICPA, Statement on Quality Control Standards No. 7, *A Firm's System of Quality Control* (October 2007).

Appendix 1—Auditing Standard No. 7

Engagement Quality Review

[Supersedes SECPS Requirements of Membership 1000.08(f).]

Applicability of Standard

1. An engagement quality review and concurring approval of issuance are required for each audit engagement and for each engagement to review interim financial information conducted pursuant to the standards of the Public Company Accounting Oversight Board ("PCAOB").

Objective

2. The objective of the engagement quality reviewer is to perform an evaluation of the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report, if a report is to be issued, in order to determine whether to provide concurring approval of issuance.[1]

Qualifications of an Engagement Quality Reviewer

3. The engagement quality reviewer must be an associated person of a registered public accounting firm. An engagement quality reviewer from the firm that issues the engagement report (or communicates an engagement conclusion, if no report is issued) must be a partner or another individual in an equivalent position. The engagement quality reviewer may also be an individual from outside the firm.[2]

4. As described below, an engagement quality reviewer must have competence, independence, integrity, and objectivity.

> Note: The firm's quality control policies and procedures should include provisions to provide the firm with reasonable assurance that the engagement quality reviewer has sufficient competence, independence, integrity, and objectivity to perform the engagement quality review in accordance with the standards of the PCAOB.

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[1] In the context of an audit, "engagement report" refers to the audit report (or reports if, in an integrated audit, the auditor issues separate reports on the financial statements and internal control over financial reporting). In the context of an engagement to review interim financial information, the term refers to the report on interim financial information. An engagement report might not be issued in connection with a review of interim financial information. See paragraph .03 of AU section ("sec.") 722, *Interim Financial Information*.

[2] An outside reviewer who is not already associated with a registered public accounting firm would become associated with the firm issuing the report if *he or she* (rather than, or in addition to, his or her firm or other employer): (1) receives compensation from the firm issuing the report for performing the review or (2) performs the review as agent for the firm issuing the report. See PCAOB Rule 1001(p)(i) for the definition of an associated person of a registered public accounting firm.

Competence

5. The engagement quality reviewer must possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the engagement partner on the engagement under review.[3]

Independence, Integrity, and Objectivity

6. The engagement quality reviewer must be independent of the company, perform the engagement quality review with integrity, and maintain objectivity in performing the review.

> Note: The reviewer may use assistants in performing the engagement quality review. Personnel assisting the engagement quality reviewer also must be independent, perform the assigned procedures with integrity, and maintain objectivity in performing the review.

7. To maintain objectivity, the engagement quality reviewer and others who assist the reviewer should not make decisions on behalf of the engagement team or assume any of the responsibilities of the engagement team. The engagement partner remains responsible for the engagement and its performance, notwithstanding the involvement of the engagement quality reviewer and others who assist the reviewer.

8. The person who served as the engagement partner during either of the two audits preceding the audit subject to the engagement quality review may not be the engagement quality reviewer. Registered firms that qualify for the exemption under Rule 2-01(c)(6)(ii) of Regulation S-X, 17 C.F.R. 210.2-01(c)(6)(ii), are exempt from the requirement in this paragraph.

Engagement Quality Review for an Audit

Engagement Quality Review Process

9. In an audit engagement, the engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report. To evaluate such judgments and conclusions, the engagement quality reviewer should, to the extent necessary to satisfy the requirements of paragraphs 10 and 11: (1) hold discussions with the engagement partner and other members of the engagement team, and (2) review documentation.

10. In an audit, the engagement quality reviewer should:

a. Evaluate the significant judgments that relate to engagement planning, including—

— The consideration of the firm's recent engagement experience with the company and risks identified in connection with the firm's client acceptance and retention process,

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[3] The term "engagement partner" has the same meaning as the phrases "auditor with final responsibility for the audit" in AU sec. 311, *Planning and Supervision*, and "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-incharge of an attest engagement.

— The consideration of the company's business, recent significant activities, and related financial reporting issues and risks, and

— The judgments made about materiality and the effect of those judgments on the engagement strategy.

b. Evaluate the engagement team's assessment of, and audit responses to—

— Significant risks identified by the engagement team, including fraud risks, and

— Other significant risks identified by the engagement quality reviewer through performance of the procedures required by this standard.

Note: A *significant risk* is a risk of material misstatement that is important enough to require special audit consideration.

c. Evaluate the significant judgments made about (1) the materiality and disposition of corrected and uncorrected identified misstatements and (2) the severity and disposition of identified control deficiencies.

d. Review the engagement team's evaluation of the firm's independence in relation to the engagement.

e. Review the engagement completion document[4] and confirm with the engagement partner that there are no significant unresolved matters.

f. Review the financial statements, management's report on internal control, and the related engagement report.

g. Read other information in documents containing the financial statements to be filed with the Securities and Exchange Commission ("SEC")[5] and evaluate whether the engagement team has taken appropriate action with respect to any material inconsistencies with the financial statements or material misstatements of fact of which the engagement quality reviewer is aware.

h. Based on the procedures required by this standard, evaluate whether appropriate consultations have taken place on difficult or contentious matters. Review the documentation, including conclusions, of such consultations.

i. Based on the procedures required by this standard, evaluate whether appropriate matters have been communicated, or identified for communication, to the audit committee, management, and other parties, such as regulatory bodies.

Evaluation of Engagement Documentation

11. In an audit, the engagement quality reviewer should evaluate whether the engagement documentation that he or she reviewed when performing the procedures required by paragraph 10—

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[4] Paragraph 13 of PCAOB Auditing Standard No. 3, *Audit Documentation*, requires the auditor to identify all significant findings or issues in an engagement completion document.

[5] See paragraphs .04–.06 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*; AU sec. 711, *Filings Under Federal Securities Statutes*.

a. Indicates that the engagement team responded appropriately to significant risks, and

b. Supports the conclusions reached by the engagement team with respect to the matters reviewed.

Concurring Approval of Issuance

12. In an audit, the engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care[6] the review required by this standard, he or she is not aware of a significant engagement deficiency.

Note: A *significant engagement deficiency* in an audit exists when (1) the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.

13. In an audit, the firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance.[7]

Engagement Quality Review for a Review of Interim Financial Information

Engagement Quality Review Process

14. In an engagement to review interim financial information, the engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report, if a report is to be issued. To evaluate such judgments and conclusions, the engagement quality reviewer should, to the extent necessary to satisfy the requirements of paragraphs 15 and 16: (1) hold discussions with the engagement partner and other members of the engagement team, and (2) review documentation.

15. In a review of interim financial information, the engagement quality reviewer should:

a. Evaluate the significant judgments that relate to engagement planning, including the consideration of—

— The firm's recent engagement experience with the company and risks identified in connection with the firm's client acceptance and retention process,

— The company's business, recent significant activities, and related financial reporting issues and risks, and

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[6] See AU sec. 230, *Due Professional Care in the Performance of Work*.

[7] Concurring approval of issuance by the engagement quality reviewer also is required when reissuance of an engagement report requires the auditor to update his or her procedures for subsequent events. In that case, the engagement quality reviewer should update the engagement quality review by addressing those matters related to the subsequent events procedures.

— The nature of identified risks of material misstatement due to fraud.

b. Evaluate the significant judgments made about (1) the materiality and disposition of corrected and uncorrected identified misstatements and (2) any material modifications that should be made to the disclosures about changes in internal control over financial reporting.

c. Perform the procedures described in paragraphs 10.d and 10.e.

d. Review the interim financial information for all periods presented and for the immediately preceding interim period, management's disclosure for the period under review, if any, about changes in internal control over financial reporting, and the related engagement report, if a report is to be issued.

e. Read other information in documents containing interim financial information to be filed with the SEC[8] and evaluate whether the engagement team has taken appropriate action with respect to material inconsistencies with the interim financial information or material misstatements of fact of which the engagement quality reviewer is aware.

f. Perform the procedures in paragraphs 10.h and 10.i

Evaluation of Engagement Documentation

16. In a review of interim financial information, the engagement quality reviewer should evaluate whether the engagement documentation that he or she reviewed when performing the procedures required by paragraph 15 supports the conclusions reached by the engagement team with respect to the matters reviewed.

Concurring Approval of Issuance

17. In a review of interim financial information, the engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care the review required by this standard, he or she is not aware of a significant engagement deficiency.

Note: A *significant engagement deficiency* in a review of interim financial information exists when (1) the engagement team failed to perform interim review procedures necessary in the circumstances of the engagement, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.

18. In a review of interim financial information, the firm may grant permission to the client to use the engagement report (or communicate an engagement conclusion to its client, if no report is issued) only after the engagement quality reviewer provides concurring approval of issuance.

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[8] See AU sec. 722.18f; AU sec. 711.

Documentation of an Engagement Quality Review

19. Documentation of an engagement quality review should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of this standard, including information that identifies:

a. The engagement quality reviewer, and others who assisted the reviewer,

b. The documents reviewed by the engagement quality reviewer, and others who assisted the reviewer,

c. The date the engagement quality reviewer provided concurring approval of issuance or, if no concurring approval of issuance was provided, the reasons for not providing the approval.

20. Documentation of an engagement quality review should be included in the engagement documentation.

21. The requirements related to retention of and subsequent changes to audit documentation in PCAOB Auditing Standard No. 3, *Audit Documentation*, apply with respect to the documentation of the engagement quality review.

Appendix 2—Conforming Amendment to PCAOB Interim Quality Control Standards

QC sec. 20, "System of Quality Control for a CPA Firm's Accounting and Auditing Practice"

QC section ("sec.") 20, "System of Quality Control for a CPA Firm's Accounting and Auditing Practice" of the Board's interim quality control standards is amended as follows—

The third sentence of paragraph .18 of QC sec. 20 is replaced with the following sentence:

> These policies and procedures also should address engagement quality reviews pursuant to PCAOB Auditing Standard No. 7, *Engagement Quality Review*.

Appendix 3—Analysis of Significant Differences between the Requirements of Auditing Standard No. 7, *Engagement Quality Review*, of the PCAOB and the Analogous Standards of the IAASB, and the Auditing Standards Board of the AICPA

Introduction

This appendix includes an analysis of significant differences between Auditing Standard No. 7, *Engagement Quality Review* ("AS No. 7" or the "EQR standard") of the Public Company Accounting Oversight Board ("PCAOB"), and the analogous standards of the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA"),[1] and the International Auditing and Assurance Standards Board ("IAASB").[2] This analysis may not represent the views of the ASB or IAASB regarding the interpretation of their standards.

Appendix 3 is provided for informational purposes only. It describes only certain provisions of AS No. 7, and is not a substitute for the standard itself. The full text of AS No. 7 is included in Appendix 1 of this release. Compliance with AS No. 7 is required for registered public accounting firms. Compliance with the analogous ASB and IAASB standards is not sufficient to meet the requirements of AS No. 7.

The Board has developed AS No. 7 to enhance the quality of the engagement quality review ("EQR") process by strengthening the provisions of the Board's interim standard.[3] Recently, the ASB and IAASB also updated their standards related to the EQR, and the Board considered information in the standards of the ASB and IAASB when developing its new EQR standard. As described in this appendix, AS No. 7 includes provisions that are similar in terminology and substance to those in the ASB and IAASB standards, and other provisions added as necessary by the Board. For example, the Board included certain provisions in AS No. 7 that are not included in the standards of the ASB or IAASB to: comply with the requirements of the Sarbanes-Oxley Act ("the Act"); respond to the feedback received on the interim standard from the Board's Standing Advisory Group ("SAG") and information obtained through PCAOB oversight of registered firms; and to ensure consistency of the provisions of AS No. 7 with the provisions and terminology of other relevant standards of the PCAOB.

Some of the provisions of the IAASB standards described in this appendix are included in the "Application and Other Explanatory Material" section of these standards. That section "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA."[4] In contrast, the

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[1] AICPA, Statement on Quality Control Standards No. 7 ("SQCS No. 7"), *A Firm's System of Quality Control* (October 2007).

[2] International Standard on Quality Control 1 ("ISQC 1"), *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, and International Standard on Auditing 220 ("ISA 220"), *Quality Control for an Audit of Financial Statements*, issued in December 2008.

[3] The Securities and Exchange Commission Practice Section ("SECPS") of the AICPA Requirements of Membership Sections 1000.08(f); 1000.39, Appendix E.

[4] See paragraph A59 of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

comparable provisions of AS No. 7 are included in the standard, and establish requirements.

Applicability

PCAOB

Section 103 of the Act requires the Board to adopt an EQR standard for audit engagements.[5] Because of the importance of interim financial information to investors, the Board has decided to include a requirement to perform an EQR for reviews of interim financial information performed in accordance with AU section ("sec.") 722, *Interim Financial Information*, ("interim reviews") in the EQR standard. Accordingly, AS No. 7 requires an EQR and concurring approval of issuance for each audit engagement and for each interim review engagement conducted pursuant to the standards of the PCAOB.[6]

ASB

SQCS No. 7 does not require an EQR for any type of engagement. Accounting firms should determine whether an EQR is required for any engagement.[7]

IAASB

ISQC 1 requires an EQR only for audits of financial statements of listed entities. Accounting firms should determine whether an EQR is required for any other engagements.[8]

Qualifications of a Reviewer

PCAOB

Associated Person—In order to obtain cooperation with the Board of the individuals that perform an EQR,[9] the Board included in AS No. 7 a requirement, according to which the engagement quality reviewer must be an associated person of a registered public accounting firm.[10]

A Reviewer from Outside the Firm—Similar to the standards of the ASB and IAASB, AS No. 7 allows a qualified individual from outside the firm to perform an EQR.[11]

Partner or Person in an Equivalent Position—Because the EQR is intended to be an objective "second look" at work performed by the engagement team, the reviewer should possess sufficient authority to be able to withstand pressure

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[5] See Section 103(a)(2)(A)(ii) of the Act.

[6] See paragraph 1 of AS No. 7.

[7] See paragraphs 80-81 and 83 of SQCS No. 7.

[8] See paragraphs 35(a)-(b) of ISQC 1.

[9] A registered public accounting firm has an obligation to secure and enforce consents to cooperate with the Board from each associated person of the firm, see Section 102(b)(3) of the Act, including those who become associated with the firm by performing the review. The Board also may directly sanction any such person who fails to cooperate in an investigation or inspection. See Section 105(b)(3) of the Act and PCAOB Rules 5110 and 4006.

[10] See paragraph 3 of AS No. 7.

[11] See id..

from the engagement partner or other firm personnel, such as members of the firm's national office. The Board believes that concerns about authority will most often arise when the reviewer and the engagement partner are from the same firm. Therefore, the Board included in AS No. 7 the requirement that an in-house reviewer—but not one from outside the firm—be a partner or another individual in an equivalent position.[12]

General Competence Requirement—The Board included in AS No. 7 a requirement for the reviewer to possess the level of knowledge and competence related to accounting, auditing, and financial reporting required to serve as the engagement partner on the engagement under review.[13] Without such knowledge and competence, the reviewer would not be able to appropriately evaluate the significant judgments made and related conclusions reached by the engagement team in an audit or an interim review.

Independence, Integrity, and Objectivity—The reviewer must comply with all applicable independence requirements,[14] and perform the review with integrity and objectivity.[15] The engagement quality reviewer should be able to take a step back and conduct the review from the perspective of an outsider looking in.

Accordingly, AS No. 7 requires that the firm's quality control policies and procedures should include provisions to provide the firm with reasonable assurance that the engagement quality reviewer has sufficient competence, independence, integrity, and objectivity to perform the engagement quality review in accordance with the standards of the PCAOB.[16] As described later, the ASB and IAASB contain similar provisions, except the standards of IAASB do not include the direction on independence for the reviewer.

While AS No. 7 does not contain the direction included in the standards of ASB and IAASB that the firm's policies and procedures should establish the degree to which a reviewer can be consulted on the engagement without compromising his or her objectivity,[17] or provide for the replacement of the reviewer when the reviewer's ability to perform an objective review has been, or may be, impaired,[18] such direction is implicit in the requirement of AS No. 7 that a reviewer must maintain objectivity in performing the EQR.[19] Importantly, AS No. 7 provides direction on maintaining objectivity, according to which the engagement quality reviewer and others who assist the reviewer should not make decisions on behalf of the engagement team or assume any of the responsibilities of the engagement team.[20]

"Cooling-off" period—An engagement quality reviewer is expected to take a fresh, objective look at the engagement. The Board believes that it would be harder for an engagement partner, who has had overall responsibility for the

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[12] See id.

[13] See paragraph 5 of AS No. 7. PCAOB interim quality control standards describe the competencies required of a person who has the overall responsibility for an engagement (or any practitioner-in-charge of an attest engagement). See 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*.

[14] See, e.g., Rule 2-01(c)(6) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(6) (subjecting the engagement quality reviewer to the five-year partner rotation requirement).

[15] See ET sec. 102, *Integrity and Objectivity*, and ET sec. 191, *Ethics Rulings on Independence, Integrity, and Objectivity*.

[16] See paragraph 4 of AS No. 7.

[17] See paragraph 96 of SQCS No. 7; paragraph 39(b) of ISQC 1.

[18] See paragraph 97 of SQCS No. 7; paragraph 41 of ISQC 1.

[19] See paragraph 6 of AS No. 7.

[20] See paragraph 7 of AS No. 7.

audit for a year or more, to perform the EQR with the necessary level of objectivity. Accordingly, AS No. 7 includes a requirement, according to which the reviewer may not be the person who served as the engagement partner during either of the two audits preceding the audit subject to the EQR. (Registered firms that qualify for the exemption under Rule 2- 01(c)(6)(ii) of Regulation S-X, 17 C.F.R. §210.2-01(c)(6)(ii), are exempt from this requirement.)[21]

ASB

SQCS No. 7 requires an auditing firm to establish the engagement quality reviewer qualifications, including those related to experience, authority, and objectivity.[22] SQCS No. 7 describes the engagement quality reviewer as a partner, other person in the firm, qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to perform the EQR.[23] According to SQCS No. 7, what constitutes sufficient and appropriate technical experience, and authority depends on the circumstances of the engagement.[24]

SQCS No. 7 does not include a "cooling-off" period, or a requirement for the reviewer to be an associated person of a registered public accounting firm.

Similar to AS No. 7, SQCS No. 7 requires that the firm establish policies and procedures designed to maintain the objectivity of the reviewer, and that such policies and procedures provide that the reviewer should satisfy the independence requirements relating to the engagements reviewed.[25] Unlike AS No. 7, SQCS No. 7 does not provide a specific direction on maintaining objectivity. Instead, SQCS No. 7 provides examples of policies and procedures for maintaining the objectivity of the reviewer.[26]

IAASB

ISQC 1 requires an auditing firm to establish the engagement quality reviewer qualification requirements, including those related to experience, authority, and objectivity.[27] The engagement quality reviewer is described as a partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the report.[28] The application materials in ISQC 1 state that what constitutes sufficient and appropriate technical expertise, experience and authority depends on the circumstances of the engagement.[29]

ISQC 1 and ISA 220 do not include reviewer independence or "cooling-off" requirements, or a requirement for the reviewer to be an associated person of a registered public accounting firm.

Similar to AS No. 7, ISQC 1 requires that the firm establish policies and procedures designed to maintain the objectivity of the reviewer.[30] Unlike AS No. 7,

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[21] See paragraph 8 of AS No. 7.

[22] See paragraphs 92-94 of SQCS No. 7.

[23] See paragraph 5.e of SQCS No. 7.

[24] See paragraph 93 of SQCS No. 7.

[25] See paragraph 94 of SQCS No. 7.

[26] See paragraph 95 of SQCS No. 7.

[27] See paragraphs 39 and 40 of ISQC 1.

[28] See paragraph 12(e) of ISQC 1; paragraph 7(c) of ISA 220.

[29] See paragraph A47 of the Application and Other Explanatory Materials of ISQC 1.

[30] See paragraph 40 of ISQC 1.

the IAASB standards do not provide specific direction on maintaining objectivity. Instead, the application materials of ISQC 1 discuss policies and procedures for maintaining the objectivity of the reviewer.[31]

Engagement Quality Review for an Audit

Engagement Quality Review Process

PCAOB

Similar to the standards of the ASB and IAASB, AS No. 7 requires the reviewer to evaluate the significant judgments made and the related conclusions reached by the engagement team in forming the overall conclusion on the engagement and in preparing the engagement report; and to carry out the review through discussions with those performing the engagement and the review of documentation.[32]

Further, AS No. 7 specifically requires the reviewer, among other things, to evaluate:

- The significant judgments that relate to engagement planning;[33]
- The engagement team's assessment of and audit responses to significant risks, including fraud risks;[34] and
- The significant judgments made about identified misstatements and control deficiencies.[35]

Also, AS No. 7 contains a requirement, similar to a requirement for audits of listed entities in ISA 220, according to which the reviewer, based on the procedures required by the standard, should evaluate whether appropriate consultations have taken place on difficult or contentious matters, and review the documentation, including conclusions, of such consultations.[36]

According to PCAOB Rule 3520, *Auditor Independence*, "[a] registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period." Because of the importance of compliance with PCAOB and Securities and Exchange Commission ("SEC") independence requirements, AS No. 7 requires the reviewer to review the engagement team's evaluation of the firm's independence in relation to the engagement.[37]

In 2004, the Board adopted Auditing Standard No. 3, Audit Documentation ("AS No. 3"). According to paragraph 13 of AS No. 3, the auditor must identify all significant findings or issues in an engagement completion document. AS No. 7 requires the reviewer to review the engagement completion document and confirm with the person who has overall responsibility for the engagement that there are no significant unresolved matters.[38]

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[31] See paragraph A49 of the Application and Other Explanatory Materials of ISQC 1.

[32] See paragraph 9 of AS No. 7.

[33] See paragraph 10.a of AS No. 7.

[34] See paragraph 10.b of AS No. 7.

[35] See paragraph 10.c of AS No. 7.

[36] See paragraph 10.h of AS No. 7.

[37] See paragraph 10.d of AS No. 7.

[38] See paragraph 10.e of AS No. 7.

Similar to the standards of the ASB and IAASB, AS No. 7 requires the reviewer to review the financial statements and the related engagement report.[39] Additionally, because an integrated audit includes an audit of internal control over financial reporting,[40]AS No. 7 requires the reviewer to review management's report on internal control.[41]

An issuer may publish various documents that contain information in addition to audited financial statements and the auditor's report thereon. The auditor is required to read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.[42] Accordingly, AS No. 7 requires the reviewer to read other information in documents containing the financial statements to be filed with the SEC and evaluate whether the engagement team has taken appropriate action with respect to any material inconsistencies with the financial statements or material misstatements of fact of which the engagement quality reviewer is aware.[43]

Finally, because of the importance to the audit process of effective communication between the auditor and those charged with governance, AS No. 7 requires the reviewer, based on the procedures required by the standard, to evaluate whether appropriate matters have been communicated, or identified for communication, to the audit committee, management, and other parties, such as regulatory bodies.[44]

ASB

Similar to AS No. 7, SQCS No. 7 requires that the EQR procedures include an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report.[45] The EQR performed in accordance with SQCS No. 7 should include: reading the financial statements or other subject matter information and the report and considering whether the report is appropriate; review of selected documentation; and a discussion with the engagement partner regarding significant findings and issues.[46]

In addition to the required procedures summarized in the preceding paragraph, an EQR performed in accordance with SQCS No. 7 may include consideration of certain other matters, examples of which are provided in the standard. SQCS No. 7 also provides examples of significant judgments that could be made by the engagement team.[47]

IAASB

The EQR procedures required by the standards of the IAASB are similar to those required by the ASB.[48] Additionally, for audits of listed entities, the IAASB standards require the reviewer to consider: the engagement team's evaluation of the firm's independence in relation to the engagement; and whether

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[39] See paragraph 10.f of AS No. 7.

[40] PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* establishes requirements and provides direction that apply when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting.

[41] See paragraph 10.f of AS No. 7.

[42] See AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

[43] See paragraph 10.g of AS No. 7.

[44] See paragraph 10.i of AS No. 7.

[45] See paragraph 85 of SQCS No. 7.

[46] See paragraphs 86 and 87 of SQCS No. 7.

[47] See paragraphs 88 and 89 of SQCS No. 7.

[48] See paragraph 37 of ISQC 1; paragraph 20 of ISA 220.

appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.[49]

Evaluation of Engagement Documentation

PCAOB

AS No. 7 includes a documentation review requirement that is similar to the requirement for audits of listed entities in the IAASB standards. According to AS No. 7, the reviewer should evaluate whether the engagement documentation that he or she reviewed when performing the required EQR procedures indicates that the engagement team responded appropriately to significant risks and supports the conclusions reached by the engagement team with respect to the matters reviewed.[50]

ASB

Unlike AS No. 7, SQCS No. 7 does not require the reviewer to evaluate whether the engagement documentation satisfies certain criteria. Instead, SQCS No. 7 states that an EQR may include consideration of whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached.[51]

IAASB

Similar to AS No. 7, the IAASB standards require, for audits of financial statements of listed entities, that the reviewer consider whether audit documentation selected for review reflects the work performed in relation to the significant judgments and supports the conclusions reached.[52]

Concurring Approval of Issuance and Resolution of Differences of Opinion

PCAOB

Under the Act,[53] the Board's standard on EQR must require concurring approval of issuance of each audit report. AS No. 7 states that the engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care the review required by the standard, he or she is not aware of a significant engagement deficiency.[54] The firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance.[55]

Unlike the standards of the ASB and IAASB, AS No. 7 does not include an explicit provision for addressing differences of opinion. Firms may develop their

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[49] See paragraphs 38(a) and 38(b) of ISQC 1; paragraphs 21(a) and 21(b) of ISA 220.

[50] See paragraph 11 of AS No. 7.

[51] See paragraph 88 of SQCS No. 7.

[52] See paragraph 38(c) of ISQC 1; paragraph 21(c) of ISA 220.

[53] See Section 103(a)(2)(A)(ii) of the Act.

[54] According to paragraph 12 of AS No. 7, "A significant engagement deficiency in an audit exists when (1) the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client."

[55] See paragraph 13 of AS No. 7.

own procedures for resolving such differences. Ultimately, however, under the standard, the reviewer may not provide concurring approval of issuance if there remains a significant engagement deficiency. If no concurring approval is provided, AS No. 7 requires that the EQR documentation include information that identifies the reasons for not providing the approval.

ASB

SQCS No. 7 does not include a requirement for the engagement quality reviewer to provide concurring approval of issuance. Instead, SQCS No. 7 requires the EQR be completed before the engagement report is released.[56] According to SQCS No. 7, when the engagement quality reviewer makes recommendations that the engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the firm's procedures for dealing with differences of opinion apply.[57] The firm's policies and procedures should require that conclusions reached be documented and implemented, and the engagement report not be released until the matter, on which the difference of opinion has arisen, is resolved.[58]

IAASB

The standards of the IAASB do not include a requirement for the engagement quality reviewer to provide concurring approval of issuance. Instead, the IAASB standards require that the engagement partner should not date the auditor's report until the completion of the EQR.[59] If differences of opinion arise between the engagement partner and the engagement quality reviewer, ISA 220 requires the engagement team to follow the firm's policies and procedures for dealing with and resolving differences of opinion.[60] ISQC 1 requires the firm to establish policies and procedures for dealing with and resolving differences of opinion between the engagement partner and the engagement quality reviewer. Such policies and procedures shall require that conclusions reached be documented and implemented, and the report not be dated until the matter is resolved.[61]

Documentation of an EQR

PCAOB

Because of deficiencies in the documentation of concurring reviews, the Board decided to strengthen the existing documentation requirements. AS No. 7 requires that documentation of an EQR should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer, and others who assisted the reviewer, to comply with the provisions of the standard, including information that identifies: the engagement quality reviewer, and others who assisted the reviewer; the documents reviewed by the engagement quality reviewer and others who assisted the reviewer; and the date the engagement quality reviewer provided concurring approval of issuance

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[56] See paragraph 81 of SQCS No. 7.

[57] See paragraph 91 of SQCS No. 7.

[58] See paragraph 78 of SQCS No. 7.

[59] See paragraph 36 of ISQC 1; paragraph 19(c) of ISA 220.

[60] See paragraph 22 of ISA 220.

[61] See paragraphs 43-44 of ISQC 1.

or, if no concurring approval of issuance was provided, the reasons for not providing the approval.[62]

Unlike the standards of the ASB or the IAASB, AS No. 7 requires that the documentation of an EQR be included in the engagement documentation and provides requirements related to retention of and subsequent changes to the EQR documentation.[63]

ASB

According to SQCS No. 7, the documentation of an EQR should state that the procedures required by the firm's policies on EQR have been performed, the EQR has been completed before the report is released, and the reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.[64]

SQCS No. 7 requires that the firm should: establish procedures designed to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation; and establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm, professional standards, laws, and regulations.[65]

IAASB

The engagement quality reviewer is required to document that the procedures required by the firm's policies on the EQR have been performed, the EQR has been completed on or before the date of the auditor's report, and the reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.[66]

ISQC 1 requires that the firm should establish policies and procedures related to the completion of the assembly of final engagement files; confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation; and retention of engagement documentation.[67]

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[62] See paragraph 19 of AS No. 7.

[63] See paragraph 20–21 of AS No. 7.

[64] See paragraph 99 of SQCS No. 7.

[65] See paragraphs 63-71 of SQCS No. 7.

[66] See paragraph 42 of ISQC 1; paragraph 25 of ISA 220.

[67] See paragraphs 45-47 of ISQC 1.

PCAOB Release No. 2010-004

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

PCAOB Release No. 2010-004
August 5, 2010
PCAOB Rulemaking
Docket Matter No. 026

Summary

After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") is adopting eight auditing standards related to the auditor's assessment of and response to risk that will supersede six of the Board's interim auditing standards and related amendments to PCAOB standards. The eight auditing standards and related amendments will be applicable to all registered firms conducting audits in accordance with PCAOB standards.

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I. Introduction

The Board is adopting 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.[1] 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

[1] 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*.

standards also allowed the auditor to use tests of controls to reduce substantive testing.[2]

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;[3] advice from the Board's Standing Advisory Group ("SAG");[4] 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").[5] 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*.[6] 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 integrated audit when the auditor is performing an integrated audit.

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

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[2] AU sec. 319.

[3] 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://pcaobus.org/News/Events/Pages/02162005_SAGMeeting.aspx.

[4] Webcasts of SAG meetings are available on the Board's Web site at: http://pcaobus.org/News/Webcasts/Pages/default.aspx.

[5] PCAOB Release No. 2008-006, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (October 21, 2008).

[6] Paragraphs .14–.51 and paragraphs .68–.78 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

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").[7]

The Board received 23 comment letters on the reproposed standards.[8] The Board discussed the comments received with the SAG on April 8, 2010.[9] 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*

Appendices 1–8 of this release present the auditing standards, and Appendix 9 presents the related amendments to PCAOB standards.

II. 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. Appendix 10 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,

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[7] PCAOB Release No. 2009-007, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (December 17, 2009).

[8] Comments on the original proposed standards and the reproposed standards are available on the Board's Web site at: http://pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx.

[9] A transcript of the portion of the meeting that related to the reproposed standards is available on the Board's Web site at: http://pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx.

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 performed by other auditors.[10] Appendix 10 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.[11] 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.[12]

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

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[10] 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*.

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

[12] Paragraphs 61 and B13 of Auditing Standard No. 5.

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.[13] 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.[14] 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.[15]

III. Additional Discussion of Standards and Comments

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.

Appendix 10 of this release has been expanded to provide additional background for certain requirements in the Board's standards and further discussion of the Board's responses to comments, including the basis for its conclusions regarding certain requirements.

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[13] Paragraph 34 of Auditing Standard No. 5.

[14] Paragraphs 37–38 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

[15] Paragraph 13 of Auditing Standard No. 12 and paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results*.

In analyzing comments on the appendix to the reproposed standards that compared the reproposed standards to the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants, 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, e.g., in the appendix that provided additional discussion of comments.

Appendix 10 of this release discusses the principal rationale for the objectives and requirements in the standards being adopted today. Appendix 11 of this release 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, Appendix 11 contains a reference to the discussion of the Board's requirements in Appendix 10.

IV. Effective Date

The release accompanying the reproposed standards stated that the Board expects that the standards would be effective for audits of fiscal years beginning on or after December 15, 2010, subject to approval by the Securities and Exchange Commission ("SEC"), 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 SEC 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.

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On the 5th day of August, in the year 2010, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ J. Gordon Seymour
J. Gordon Seymour
Secretary

APPENDICES—

1. Auditing Standard No. 8—*Audit Risk*
2. Auditing Standard No. 9—*Audit Planning*
3. Auditing Standard No. 10—*Supervision of the Audit Engagement*
4. Auditing Standard No. 11—*Consideration of Materiality in Planning and Performing an Audit*
5. Auditing Standard No. 12—*Identifying and Assessing Risks of Material Misstatement*
6. Auditing Standard No. 13—*The Auditor's Responses to the Risks of Material Misstatement*
7. Auditing Standard No. 14—*Evaluating Audit Results*

Appendix 1—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]

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[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. 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 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]

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[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.*

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

Appendix 2—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** [1] 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.[2]

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,[3]

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.

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

[2] 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.

[3] 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.

c. Establish an understanding with the client regarding the services to be performed on the engagement.[4]

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,[5] risk, and, in integrated audits, other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee[6] 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

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

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

[6] 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).

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,[7]

b. The factors that are significant in directing the activities of the engagement team,[8]

c. The results of preliminary engagement activities[9] 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.[10]

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;[11]

b. The planned nature, timing, and extent of tests of controls and substantive procedures;[12] 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,[13] 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

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[7] 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.

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

[9] Paragraph 6 of this standard.

[10] 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*.

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

[12] 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.*

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

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;[14]

b. The materiality of the location or business unit;[15]

c. The specific risks associated with the location or business unit that present a reasonable possibility[16] 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[17] 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.

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

[15] 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.

[16] 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.

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

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.[18] 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:

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.[19]

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

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

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.

Appendix 3—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**[1] 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,[2] other auditors,[3] internal auditors,[4] and others who are involved in testing controls.[5] Paragraphs 5–6 of this standard describe the nature and extent of supervisory activities necessary for proper supervision of engagement team members.[6]

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:

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

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

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

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

[5] 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.*

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

a. Inform engagement team members of their responsibilities,[7] 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,[8] 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;[9]

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.[10]

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;[11]

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

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[7] 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.

[8] 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.

[9] 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.*

[10] 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.

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

d. The knowledge, skill, and ability of each engagement team member.[12]

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.[13]

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

[13] 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.

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.

Appendix 4—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.[1]

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."[2] 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 ...."[3]

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.[4] 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."[5]

Objective

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

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

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

[3] TSC Industries, 426 U.S. at 450.

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

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

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 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.[6]

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

Appendix 5—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[1] of the financial statements.

2. Paragraphs 4–58 of this standard discuss the auditor's responsibilities for performing **risk assessment procedures**.[2] 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.

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,[3] and designing further audit procedures.[4]

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);

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

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

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

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

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).

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.[5]

6. In an integrated audit, the risks of material misstatement of the financial statements are the same for both the audit of internal control over financial reporting and the audit of 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.

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

Industry, Regulatory, and Other External Factors

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

Nature of the Company

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

- The 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;

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

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

- 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 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[8] of internal control over financial reporting ("understanding of internal control") to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.

19. The nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control depend on the size and complexity of the company;[9] the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's controls, including the 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.[10]

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

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

[9] 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."

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

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:[11]

- 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.[12] 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."[13] If the auditor uses a suitable, recognized internal control framework with components that differ from those listed in the preceding paragraph, the auditor should adapt the requirements in paragraphs 23–36 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

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

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

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

- Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

  Note: In an audit of financial statements only, this assessment may be based on the evidence obtained in understanding the control environment, in accordance with paragraph 23, and the other relevant knowledge possessed by the auditor. In an integrated audit of financial statements and internal control over financial reporting, Auditing Standard No. 5[14] describes the auditor's responsibility for evaluating the control environment.

25. If the auditor identifies a control deficiency[15] 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,[16] that are significant to the financial statements; and
e. The period-end financial reporting process.

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

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

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

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;[17]
- 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

[17] Paragraphs 12–13 of this standard.

this standard.[18] 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.[19]

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 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.[20]

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

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

[19] 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.

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

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[21] or for the purpose of expressing an opinion on internal control over financial reporting in the audit of internal control over financial reporting.[22] 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."[23] 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.[24] 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

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

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

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

[24] 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.

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[25] and should take into account relevant information obtained from those engagements in identifying risks of material misstatement.[26]

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 her understanding of the company to develop expectations about plausible relationships among the data to be used in the procedure.[27] 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.

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

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

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

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.[28]

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.[29]

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

[28] Paragraphs 52–53 of this standard.

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

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;[30]
- 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.[31]

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.

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[30] AU sec. 316.13.

[31] 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.

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 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.[32]

e. Identify significant accounts and disclosures[33] and their relevant assertions[34] (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;
- 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;

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

[33] 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.

[34] 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.

- 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.[35]

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.

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[35] 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.

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.[36]

73. Controls that address fraud risks include (a) specific controls designed to mitigate specific risks of fraud, e.g., controls to address risks of intentional misstatement of specific accounts and (b) controls designed to prevent, deter, and detect fraud, e.g., controls to promote a culture of honesty and ethical behavior.[37] 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.[38]

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

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

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

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.

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.[1] 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.[2]

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 nonexistent 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.

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[1] 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.

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

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.

Appendix 6—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.[1]

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

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

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.[2]

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,[3] 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.[4] 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.[5] 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

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[2] 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.

[3] 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.*

[4] AU secs. 230.07–.09.

[5] AU sec. 316.13.

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;[6]

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[7] assessments for purposes of the audit of financial statements;[8] 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.[9] 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.

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

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

[8] 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.

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

Note: Auditing Standard No. 12 discusses identification of significant risks[10] 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.

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.[11]

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).

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

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

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,[12] 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**.[13] 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.[14]

> 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

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[12] 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.

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

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

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.[15]

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 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

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

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);[16]
- The complexity of the control and the significance of the judgments that must be made in connection with its operation;

[16] 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.[17] Auditing Standard No. 5 establishes requirements regarding the selection of controls to be tested and the necessary nature, timing,

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

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,[18] 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.[19]

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.

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.

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

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

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.[20]

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

Appendix A

Definitions

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

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

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

Appendix 7—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,[1] the auditor's evaluation of audit results should include evaluation of the following:

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

[1] 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.

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

in forming an opinion on whether the financial statements as a whole are free of material misstatement.

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

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

b. Unusual or unexpected transactions, events, amounts, or relationships[3] indicate risks of material misstatement that were not identified previously, including, in particular, fraud risks.

Note: If the auditor discovers a previously unidentified risk of material misstatement or concludes that the evidence gathered is not adequate, he or she should modify his or her audit procedures or perform additional procedures as necessary in accordance with paragraph 36 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.[4]

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

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[3] 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.*

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

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*.[5]

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.[6]

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.

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[5] AU sec. 350.26.

[6] Auditing Standard No. 11.

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.[7] (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."[8] 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 ...."[9]
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> 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[10] that it could lead to a material contingent liability or a material loss of revenue.[11] Also, a misstatement made intentionally could be material for qualitative reasons, even if relatively small in amount.
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> Note: If the reevaluation of the established materiality level or levels, as set forth in Auditing Standard No. 11,[12] 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

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[7] 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.

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

[9] TSC Industries, 426 U.S. at 450.

[10] 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.

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

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

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[13] 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.[14]

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.

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

[14] AU sec. 316.05.

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.[15]

d. Bias in accounting estimates.[16]

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.

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[17] 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.)

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

[16] Paragraph 27 of this standard.

[17] 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).

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.[18]

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

[18] AU secs. 508.41–.44.

to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.[19]

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.[20]

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.[21]

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.[22] 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.[23]

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

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

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

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

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

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

37. Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* indicates that the auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls, 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.[24]

[24] Paragraphs 62–70 of Auditing Standard No. 5 discuss evaluating identified control deficiencies, and paragraphs 71–73 of Auditing Standard No. 5 discuss forming an opinion on the effectiveness of internal control over financial reporting.

Appendix A

Definitions

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

A2. Misstatement—A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework.[1] A misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework. Misstatements can arise from error (i.e., unintentional misstatement) or fraud.[2]

A3. Uncorrected misstatements—Misstatements, other than those that are clearly trivial,[3] that management has not corrected.

[1] 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.

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

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

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.[1]
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> 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."[2] 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 . . . ."[3]
>
> 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[4] that it could lead to a material contingent liability or a material loss of revenue.[5] 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.

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[1] 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.

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

[3] TSC Industries, 426 U.S. at 450.

[4] 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.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Appendix C

Matters That Might Affect the Assessment of Fraud Risks

C1. If the following matters are identified during the audit, the auditor should 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.[1]
   (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.

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

(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:[2]

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.

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

Appendix 8—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.[1]

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.[2]
- *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.

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[1] 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.

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

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:[3]

- 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.

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[3] 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*.

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[4] of containing misstatements that would cause the financial statements to be materially misstated, individually or in combination with other misstatements.[5]

Audit Procedures for Obtaining Audit Evidence

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

a. Risk assessment procedures,[6] and

b. Further audit procedures,[7] 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.

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[4] 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.

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

[6] Auditing Standard No. 12.

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

Inspection

15. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or physically examining an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorization.

Observation

16. Observation consists of looking at a process or procedure being performed by others, e.g., the auditor's observation of inventory counting by the company's personnel or 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.[8]

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.[9]

> 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.[10]

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.

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

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

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

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.[11]

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.

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

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.[12]

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.[13]

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.

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

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

Appendix 9—Amendments to PCAOB 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"

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.[fn 2]

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*.

Appendix 10—Additional Discussion of Auditing Standards, Amendments to PCAOB Standards, and Comments on Reproposed Standards

This appendix discusses each of the auditing standards in Appendices 1–8 ("the risk assessment standards") and the related amendments to PCAOB standards in Appendix 9. In particular, this appendix provides additional background information for certain requirements in the standards. It discusses the Board's responses to comments on the standards reproposed on December 17, 2009 ("the reproposed standards"), including the basis for the Board's conclusions regarding certain requirements.

I. 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. At the end of this appendix is 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 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*.[1]

The number of comments received on this approach to incorporate the requirements from AU sec. 316 declined significantly from the original proposed standards.[2] 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

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[1] 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. See Appendix 9.

[2] As discussed in Section I of this release, 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*.

should prompt auditors to make a more thoughtful and thorough assessment of the risks affecting the financial statements, including fraud risks, and to develop appropriate audit responses. Furthermore, AU sec. 316, as amended, will continue to provide relevant information on determining the necessary procedures for considering fraud in a financial statement audit. (See section X.F.2. of this appendix 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.[3] Accordingly, the results of the auditor's thinking on the relevant matters should be reflected

[3] AU sec. 316.45 and paragraphs 14, 44, 59, and B12 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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 appendix 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.[4] Subsequent sections of this appendix 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.[5] 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.

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[4] See, e.g., paragraph 21 of Auditing Standard No. 5 for an example of the use of the present tense for this purpose.

[5] See, e.g., paragraph .11 of AU sec. 230, *Due Professional Care in the Performance of Work*.

II. 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 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.[6]

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,[7] 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.[8]

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

[7] AU sec. 230.10.

[8] Paragraph 6 of Auditing Standard No. 8.

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.[9]

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.[10] 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

[9] Ibid.

[10] Paragraph 8 of Auditing Standard No. 8.

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.[11] 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.[12]

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 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."[13]

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.

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[11] 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.

[12] Paragraphs 8–9 of Auditing Standard No. 8.

[13] Paragraph 10 of Auditing Standard No. 8.

III. 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.[14] Auditors also may reevaluate their engagement acceptance decision for other reasons. However, because auditors must comply with independence and ethics requirements

[14] See, e.g., paragraphs .18–.21 of AU sec. 317, *Illegal Acts by Clients.*

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 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.[15] 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.

[15] Paragraph 9 of Auditing Standard No. 9.

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.[16] 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.[17]

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 Independent Auditors,* describes the auditor's responsibilities when the auditor uses the work and reports of other independent auditors.[18]

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

[16] Paragraph 5 of Auditing Standard No. 13.

[17] Paragraphs 61 and B13 of Auditing Standard No. 5.

[18] Paragraph 14 of Auditing Standard No. 9.

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.

IV. 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 III.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,[19] other auditors,[20] internal auditors,[21] and others who are involved in testing controls.[22] 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 partner with his or her responsibilities pursuant to the standard.[23]

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.[24] 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.[25] 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

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[19] See Section IV.F. of this appendix.

[20] Ibid.

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

[22] Paragraphs 16–19 of Auditing Standard No. 5.

[23] 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*.

[24] Paragraph 5 of Auditing Standard No. 10.

[25] Paragraph 6 of Auditing Standard No. 10.

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.[26] 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[27] 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[28] 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,[29] 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

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[26] 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.

[27] AU sec. 543 uses the term "principal auditor" to refer to the auditor who issues the audit report on the financial statements presented.

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

[29] Examples of situations that are not covered by AU sec. 543 include loan staff arrangements.

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.*[30] 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 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.[31]

[30] Paragraph 12.d. of Auditing Standard No. 3.

[31] Note to paragraph 5.b. of Auditing Standard No. 10.

V. 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.[32] 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."[33]

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[34] 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.

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[32] Paragraph 2 of Auditing Standard No. 11.

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

[34] 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.

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.[35] 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.[36] 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[37] 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.

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[35] Paragraph 6 of Auditing Standard No. 11.

[36] Paragraph 3 of Auditing Standard No. 11.

[37] Paragraph 7 of Auditing Standard No. 11.

— 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.[38] 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 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.[39] 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.[40] 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 ("ISAs").

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

[38] AU sec. 312.20.

[39] Paragraphs 8–9 of Auditing Standard No. 11.

[40] AU sec. 350.18.

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.[41] 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

[41] Paragraph 10 of Auditing Standard No. 11.

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[42] and in determining an appropriate amount of tolerable misstatement for the remaining locations or business units included in the consolidated 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.[43]

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[44] 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.[45]

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[42] 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.

[43] Paragraph 12 of Auditing Standard No. 11.

[44] Paragraphs 17–23 of Auditing Standard No. 14.

[45] Paragraph 14.b. of Auditing Standard No. 14.

VI. 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.[46] Auditing Standard No. 12 discusses the auditor's responsibilities for determining and performing the risk assessment procedures necessary to satisfy that overarching requirement.[47]

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:

- Obtaining an understanding of the company and its environment;[48]
- Obtaining an understanding of the company's internal control over financial reporting;[49]
- Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company;[50]
- Performing analytical procedures;[51]
- Conducting a discussion among engagement team members regarding the risks of material misstatement;[52] and
- Inquiring of the audit committee, management, and others within the company about the risks of material misstatement.[53]

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.

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[46] 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.

[47] Paragraphs 5–58 of Auditing Standard No. 12.

[48] Paragraphs 7–17 of Auditing Standard No. 12.

[49] Paragraphs 18–40 of Auditing Standard No. 12.

[50] Paragraphs 41–45 of Auditing Standard No. 12.

[51] Paragraphs 46–48 of Auditing Standard No. 12.

[52] Paragraphs 49–53 of Auditing Standard No. 12.

[53] Paragraphs 54–58 of Auditing Standard No. 12.

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.[54]

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").[55] 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.[56] 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.[57]

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.[58] 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.[59]

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[54] Paragraphs 8–11 of Auditing Standard No. 8.

[55] Paragraph 7 of Auditing Standard No. 12.

[56] AU secs. 311.06–.09.

[57] Paragraph 7 of Auditing Standard No. 12.

[58] Paragraph 8 of Auditing Standard No. 12.

[59] AU sec. 319.38.

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.[60] 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.

1. 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 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.[61] Also, the Public Oversight Board, *Panel on Audit*

[60] First note to paragraph 10 of Auditing Standard No. 12.

[61] February 16, 2005. Webcasts of SAG meetings are available on the Board's website at: http://www.pcaobus.org/News_and_Events/Webcasts.

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.[62]

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.

2. 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.[63] 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.[64] 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.[65] The language in this

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[62] Public Oversight Board, *Panel on Audit Effectiveness, Report and Recommendations* (August 31, 2000), p. 58.

[63] See AU sec. 316 and AU sec. 380, *Communication With Audit Committees*.

[64] Paragraph 12 of Auditing Standard No. 12.

[65] Ibid.

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.[66] 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.[67]

3. 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.[68]

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.[69]

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.[70] However, the list of examples is meant to be illustrative rather than a checklist of factors to consider. Auditors would need to consider the business risks that are relevant to the particular company and industry. For example, in today's economic environment, business risks might include financing risks (e.g., access to necessary financing) or product risks (e.g., investments in certain financial products).

4. 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.[71]

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[66] Paragraph 13 of Auditing Standard No. 12.

[67] Paragraphs 4 and 7 of Auditing Standard No. 12.

[68] *PAE Report,* p. 20.

[69] Paragraph 6 of Auditing Standard No. 8 and the note to paragraph 15 of Auditing Standard No. 12.

[70] Paragraphs 5 and 14–15 of Auditing Standard No. 12.

[71] Paragraph 17 of Auditing Standard No 12.

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.[72] 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.[73]

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.[74] Under Auditing Standard No. 12, as under AU sec. 319,[75] 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.

1. 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

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[72] Paragraph 18 of Auditing Standard No. 12.

[73] Paragraph 19 of Auditing Standard No. 12.

[74] Paragraph 20 of Auditing Standard No. 12.

[75] AU sec. 319.58.

are similar to those in AU sec. 319.[76] Auditing Standard No. 12 also states that auditors may use other suitable, recognized frameworks[77] 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.[78]

2. 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.[79]

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.[80]

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.[81]

3. 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 actions to address those risks.[82] 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.[83] 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.

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[76] Paragraph 21 of Auditing Standard No. 12.

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

[78] Paragraph 22 of Auditing Standard No. 12.

[79] Paragraph 24 of Auditing Standard No. 12.

[80] Ibid.

[81] Paragraph 25 of Auditing Standard No. 12.

[82] Paragraph 26 of Auditing Standard No. 12.

[83] Paragraph 27 of Auditing Standard No. 12.

4. 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.[84] 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*.[85] Auditing Standard No. 12 describes the necessary understanding of business processes to help auditors identify those business processes that are relevant to financial reporting.[86]

Auditing Standard No. 12 also contains requirements for understanding the period-end financial reporting process[87] and describes important elements of that process.[88] 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[89] 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.[90]

5. 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

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[84] Paragraph 28 of Auditing Standard No. 12.

[85] *PAE Report,* p. 15.

[86] Paragraphs 28–32 of Auditing Standard No. 12.

[87] 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.

[88] Paragraphs 28 and 32 of Auditing Standard No. 12.

[89] Paragraph 20 of Auditing Standard No. 12 discusses procedures that the auditor performs to obtain an understanding of internal control.

[90] Paragraph 33 of Auditing Standard No. 12.

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.[91]

6. 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[92] 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.[93] 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.

7. 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.[94] 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[95] or for the purpose of expressing an opinion on internal control over financial reporting in the audit of internal control.[96] 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.[97]

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[91] AU sec. 319.42 and paragraph 34 of Auditing Standard No. 12.

[92] Paragraph 34 of Auditing Standard No. 5.

[93] Paragraph 37 of Auditing Standard No. 12.

[94] Paragraph 39 of Auditing Standard No. 12.

[95] Paragraphs 16–31 of Auditing Standard No. 13.

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

[97] Paragraph 39 of Auditing Standard No. 12.

F. Information Obtained from Past Audits and Other Engagements

1. 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.[98] 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.[99]

2. 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[100] 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

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[98] Paragraph 57 of Auditing Standard No. 5.

[99] Paragraph 43 of Auditing Standard No. 12.

[100] 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."

> 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[101] 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[102] and should take into account relevant information obtained from those engagements in identifying risks of material misstatement.[103]

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[104] and 3526[105] 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.[106] Such analytical procedures are, in essence, risk assessment procedures, so the respective requirements and direction have been incorporated into Auditing Standard No. 12.[107] 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.[108]

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

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[101] Paragraph 45 of Auditing Standard No. 12.

[102] PCAOB Rule 3501, *Definitions of Terms Employed in Section 3, Part 5 of the Rules*.

[103] Paragraph 7 of Auditing Standard No. 9.

[104] PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*.

[105] PCAOB Rule 3526, *Communication With Audit Committees Concerning Independence.*

[106] AU secs. 329.06–.08.

[107] Paragraphs 46–48 of Auditing Standard No. 12.

[108] AU sec. 329.05.

are not designed with the level of precision necessary for substantive analytical procedures.[109] In those situations, the auditor's expectations in performing analytical procedures as risk assessment procedures do not require the same 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.[110] The standard explains that key engagement team members include the engagement partner and all engagement team members who have significant engagement responsibilities.[111] 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.[112]

1. 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.[113]

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.[114] 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

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[109] Paragraph 48 of Auditing Standard No. 12.

[110] Paragraph 49 of Auditing Standard No. 12.

[111] Paragraph 50 of Auditing Standard No. 12.

[112] PCAOB Release 2007-001, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud* (January 22, 2007).

[113] Paragraphs 16–17 of Auditing Standard No. 12.

[114] Paragraph 52 of Auditing Standard No. 12.

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.

2. 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.[115]

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.[116] 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.[117]

1. 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.[118]

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

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[115] AU sec. 316.18.

[116] Paragraph 54 of Auditing Standard No. 12.

[117] AU sec. 316.24.

[118] Paragraph 57 of Auditing Standard No. 12.

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.[119]

Auditing Standard No. 12 requires that the auditor 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. This requirement carries forward and builds upon a requirement in AU sec. 316.[120]

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.[121] These required inquiries were added in light of research indicating that many incidents of fraud are uncovered through tips.[122] 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.[123]

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.[124] This process involves:

a. Identifying risks of misstatement using information obtained from risk assessment procedures and considering the characteristics of the accounts and disclosures in the financial statements.

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

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[119] Paragraph 58 of Auditing Standard No. 12.

[120] AU sec. 316.24.

[121] Paragraph 56 of Auditing Standard No. 12.

[122] See, e.g., Association of Certified Fraud Examiners, *2008 Report to the Nation on Occupational Fraud & Abuse* (2008).

[123] AU sec. 316.27.

[124] 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.

c. Evaluating the types of potential misstatements that could result from the identified risks and the accounts, disclosures, and assertions that could be affected. This includes evaluating how risks at the financial statement level could affect risks at the assertion level.

d. Assessing the likelihood of misstatement, including the possibility of multiple misstatements, and the magnitude of potential misstatement to assess the possibility that the risk could result in material misstatement of the financial statements. In making this assessment, the auditor may take into account the planned degree of reliance on controls that the auditor plans to test, if the auditor performs tests of controls in accordance with PCAOB standards.

e. Identifying significant accounts and disclosures and their relevant assertions.

f. Determining whether any of the identified and assessed risks of material misstatement are significant risks.[125]

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."[126] 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."[127] 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,

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

[126] Paragraph 70 of Auditing Standard No. 12.

[127] Paragraph 71 of Auditing Standard No. 12.

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.[128] 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.[129] Also, AU sec. 319 required the auditor to perform substantive procedures for the relevant assertions of significant accounts and disclosures for all audits of financial statements, which implicitly required the auditor to identify those accounts, disclosures, and assertions.[130] 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.

1. 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.[131] 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.[132]

2. 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.[133]

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[128] Paragraph 6 of Auditing Standard No. 8.

[129] Paragraph 28 of Auditing Standard No. 5.

[130] Ibid.

[131] Paragraph 65 of Auditing Standard No. 12.

[132] Paragraph 66 of Auditing Standard No. 12.

[133] Paragraph 67 of Auditing Standard No. 12.

3. 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.[134] 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.[135]

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.

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[134] Paragraph 68 of Auditing Standard No. 12.

[135] See, e.g., Committee of Sponsoring Organizations of the Treadway Commission, *Fraudulent Financial Reporting: 1998-2007 (*May 2010*).*

VII. 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.[136] 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.[137]

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,

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[136] Paragraph 3 of Auditing Standard No. 13.

[137] Failure to address a risk of material misstatement also might indicate a failure to comply with Auditing Standard No. 12.

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 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.[138]

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.[139] 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.[140]

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.[141]

Existing PCAOB standards require the auditor to apply professional skepticism as part of due care,[142] 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.[143] 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

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[138] Paragraph 5.c. of Auditing Standard No. 13.

[139] Paragraph 5.c. (1) of Auditing Standard No. 13.

[140] Paragraph 5.c. (3) of Auditing Standard No. 13.

[141] Paragraph 6 of Auditing Standard No. 13.

[142] AU secs. 230.07–.09.

[143] Paragraph 7 of Auditing Standard No. 13.

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.[144]

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.[145]

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.[146] 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

1. 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.[147] Thus, except in those limited circumstances, AU sec. 319 provided auditors with flexibility to decide when or whether to test controls.

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[144] Paragraph 9.c. of Auditing Standard No. 13.

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

[146] 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."

[147] AU sec. 319.66.

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.[148] In those audits, auditors continue to have the same flexibility in deciding when or whether to test controls to reduce their substantive procedures.[149] 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.[150]

2. 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.[151] 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.[152]

3. Evidence about the Effectiveness of Controls

Auditing Standard No. 13 describes the principle, adapted from AU sec. 319,[153] 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.[154]

4. 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.[155] 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.

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[148] 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.

[149] Paragraph 16 of Auditing Standard No. 13.

[150] Paragraph 17 of Auditing Standard No. 13.

[151] Paragraph 16 of Auditing Standard No. 13.

[152] Paragraph A.3 of Auditing Standard No. 13.

[153] AU sec. 319.90.

[154] Paragraph 18 of Auditing Standard No. 13.

[155] Paragraph 21 of Auditing Standard No. 13.

5. 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.[156]

6. 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.[157] 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.[158] 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

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[156] Paragraph 30 of Auditing Standard No. 13.

[157] Paragraph 31 of Auditing Standard No. 13.

[158] Ibid.

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.[159]

7. Assessing Control Risk

Auditing Standard No. 13 requires the auditor to assess control risk for relevant assertions.[160] 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.[161]

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.[162]

One commenter expressed a concern that the reproposed standard seemed to 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.[163] 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.[164]

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.[165]

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[159] Ibid.

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

[161] AU secs. 319.70, .83–.90 and paragraphs B4–B5 of Auditing Standards No. 5.

[162] Paragraph 33 of Auditing Standard No. 13.

[163] Paragraph 20 of Auditing Standard No. 12.

[164] Paragraph 34 of Auditing Standard No. 13.

[165] Paragraph 32 of Auditing Standard No. 13.

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.[166] 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.[167] 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.[168] 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.[169] 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

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[166] Paragraph 36 of Auditing Standard No. 13.

[167] Paragraph A9 of Auditing Standard No. 5.

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

[169] Paragraph 44.a.(3) of Auditing Standard No. 13.

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.[170]

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.[171]

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.[172] The nature and importance of significant risks warrant a high level of assurance from substantive procedures to adequately address the risk. Also, analytical procedures alone are not well suited to detecting certain types of misstatements related to significant risks, including, in particular, fraud risks. For example, when fraud risks are present, management might be able to override controls to allow adjustments that result in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions.

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.[173] 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.

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[170] Paragraph 45 of Auditing Standard No. 13.

[171] AU sec. 329.09.

[172] Paragraph 11 of Auditing Standard No. 13.

[173] Paragraph 47 of Auditing Standard No. 13.

VIII. 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.[174] 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.[175] 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.[176] 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.[177] The second sentence of the definition in Auditing Standard No. 14 describes the most common types of misstatements.[178]

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[174] 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.

[175] 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.

[176] Paragraph A2 of Appendix A to Auditing Standard No. 14.

[177] 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."

[178] See also paragraph A2 of Auditing Standard No. 14.

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.[179] 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.[180] 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.[181] 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.[182] 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.[183] 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.[184] 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 further undetected misstatement.[185] The specific limitation on setting a threshold for accumulating misstatements is important to assure a

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[179] Paragraph 5 of Auditing Standard No. 14.

[180] Paragraph 6 of Auditing Standard No. 14.

[181] Paragraph 7 of Auditing Standard No. 14.

[182] Paragraph 8 of Auditing Standard No. 14.

[183] Paragraph 17 of Auditing Standard No. 15.

[184] Paragraph 10 of Auditing Standard No. 14.

[185] Paragraph 11 of Auditing Standard No. 14.

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.[186]

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.[187] 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.[188]

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[186] Paragraphs 10–12 of Auditing Standard No. 14.

[187] Paragraph 16 of Auditing Standard No. 14.

[188] Paragraph 14 of Auditing Standard No. 14.

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.[189] 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,[190] 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.[191]

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.[192] The standard does not address

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

[190] AU secs. 9312.15–.17.

[191] AU sec. 9312 and paragraph 17 and Appendix B of Auditing Standard No. 14.

[192] Paragraph 18 of Auditing Standard No. 14.

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 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.[193] 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.[194] 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.[195] 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.

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[193] Paragraph 19 of Auditing Standard No. 14.

[194] AU sec. 316.75.

[195] Paragraph 20 of Auditing Standard No. 14.

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.[196] 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.[197]

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.[198]

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.[199]

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

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[196] Paragraphs 15 and 25 of Auditing Standard No. 14.

[197] Paragraph 23 of Auditing Standard No. 14.

[198] Paragraph 24 of Auditing Standard No. 14.

[199] Paragraph 26 of Auditing Standard No. 14.

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.[200]

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.[201] 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 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.[202]

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.[203] This requirement is adapted from the existing PCAOB standards.[204]

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

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[200] Paragraph 25 of Auditing Standard No. 14.

[201] Paragraph 28 of Auditing Standard No. 14.

[202] Paragraph C1 of Appendix C to Auditing Standard No. 14.

[203] Paragraph 29 of Auditing Standard No. 14.

[204] AU sec. 316.18.

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.[205] AU sec. 411 discusses the concept of materiality regarding the auditor's opinion that financial statements are presented fairly.[206]

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.[207]

O. Evaluating the Sufficiency and Appropriateness of Audit Evidence

The reproposed standard required the auditor to conclude on whether sufficient appropriate audit evidence has been obtained to support his or her opinion on the financial statements. The 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.[208]

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.[209]

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

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[205] Paragraph 31 of Auditing Standard No. 14.

[206] AU sec. 411.04.

[207] Paragraph 31 of Auditing Standard No. 14.

[208] Paragraphs 33–34 of Auditing Standard No. 14.

[209] Paragraph 34 of Auditing Standard No. 14.

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.[210]

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.[211] 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.

[210] Paragraph 35 of Auditing Standard No. 14.

[211] Paragraph 37 of Auditing Standard No. 14.

IX. 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 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.[212] 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."[213]

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

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[212] Paragraph 3 of Auditing Standard No. 8 and paragraph 3 of Auditing Standard No. 5, respectively.

[213] Paragraph 2 of Auditing Standard No. 15.

"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.[214]

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.[215]

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.[216] 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.[217]

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."

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[214] Paragraphs 5–6 of Auditing Standard No. 15.

[215] Paragraph 39 of Auditing Standard No. 13.

[216] Paragraph 8 of Auditing Standard No. 15.

[217] Paragraph 7 of Auditing Standard No. 15.

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.[218] 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 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.[219] Like Auditing Standard No. 5,[220] 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.[221]

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.[222]

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[218] Paragraph 9 of Auditing Standard No. 15.

[219] Paragraph 11 of Auditing Standard No. 15.

[220] See the note to paragraph 28 of Auditing Standard No. 5.

[221] Paragraph 12 of Auditing Standard No. 15.

[222] 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.[223] 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.[224]

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.[225]

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.[226] 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.[227]

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.

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[223] Paragraph 18 of Auditing Standard No. 15.

[224] PCAOB Release No. 2010-003, *Proposed Auditing Standard Related to Confirmation and Related Amendments to PCAOB Standards* (July 13, 2010).

[225] Paragraph 21 of Auditing Standard No. 15.

[226] AU sec. 9350, *Audit Sampling: Auditing Interpretations of AU sec. 350.*

[227] Paragraph 22 of Auditing Standard No. 15.

X. 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:

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.

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.[228]

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.[229] 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

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[228] Paragraph 5.a. of Auditing Standard No. 3.

[229] Paragraphs 9, 12, and 19 of Auditing Standard No. 3, as amended.

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.

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

1. 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.[230]

2. 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.

3. 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,* 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

[230] 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.

test accounts without meeting the requirements in AU sec. 329 for substantive analytical procedures.[231]

4. 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.

5. 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.

6. 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.

7. 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:

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[231] 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).

- 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.

XI. 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. Comparison with the Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

In developing its original proposed standards, the Board took into account, among other things, the risk assessment standards of the International Auditing and Assurance Standards Board ("IAASB") 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, which is analogous to this appendix (Appendix 10) to this release.

This appendix provides the principal discussion of the rationale for the objectives and requirements in the Board's standards. Appendix 11 of this release 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, Appendix 11 contains a reference to the discussion of the Board's requirements in this appendix (Appendix 10).

B. 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,[232] 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

[232] E.g., Section 101 of the Sarbanes-Oxley Act of 2002 (the "Act"), 15 U.S.C. §7211.

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.

C. 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 website. The Board is considering these comments as it assesses its agenda.

Appendix 11—Comparison of the Objectives and Requirements of the Accompanying PCAOB Auditing Standards with the Analogous Standards of the IAASB and the Auditing Standards Board of the AICPA

This appendix discusses certain differences between the objectives and requirements of the PCAOB auditing standards accompanying this release and the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the analogous clarified or proposed standards of the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA"). This analysis does not cover the application and explanatory material in the IAASB standards or the ASB standards.[1]

This appendix is provided for informational purposes only. It is not a substitute for the PCAOB auditing standards themselves, which are presented in Appendices 1–8 of this release and discussed further in Appendix 10.

Appendix 10 to this release provides the principal discussion of the rationale for the objectives and requirements in the Board's standards. Thus, this appendix includes cross-references to the relevant explanation of the PCAOB requirements.

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.

1. 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

[1] Paragraph A59 of ISA 200 states that the Application and Other Explanatory Material section of the ISAs "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA." Paragraph A63 of the SAS, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, states that although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU section."

is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence.[2]

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. Appendix 10 provides additional discussion regarding the use of the phrase "appropriately low level."[3]

Auditing Standard No. 8 also clarifies that obtaining sufficient appropriate audit evidence is part of applying due professional care. Appendix 10 provides additional discussion regarding due professional care and sufficient appropriate audit evidence.[4]

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.

2. 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*,[5] and it parallels a requirement in Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.[6] Appendix 10 provides additional discussion regarding detection risk.[7]

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.

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[2] 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.

[3] Section II.B. of Appendix 10.

[4] Section II.C. of Appendix 10.

[5] AU sec. 319 is superseded by the risk assessment standards.

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

[7] Section II.E. of Appendix 10.

1. 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.

2. 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 Appendix 10, 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").[8]

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. Appendix 10 discusses this requirement with more detail.[9]

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. Appendix 10 provides additional discussion regarding developing the audit strategy and audit plan.[10]

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.

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[8] Section III.E. of Appendix 10.

[9] Section III.F. of Appendix 10.

[10] Ibid.

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.

3. 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 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. Appendix 10 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.[11]

IAASB and ASB

ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors),* and the proposed SAS, *Audits of*

[11] Section III.G. of Appendix 10.

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").

1. 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.*[12] Appendix 10 provides additional discussion regarding these requirements.[13]

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."

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[12] AU sec. 311 is superseded by Auditing Standard No. 9 and Auditing Standard No. 10.

[13] Section IV.D. of Appendix 10.

2. 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. Appendix 10 provides additional discussion regarding this requirement.[14]

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.

3. 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

[14] Section IV.E. of Appendix 10.

risks of material misstatement, and the knowledge, skill, and ability of each engagement team member. Appendix 10 provides additional discussion regarding this requirement.[15]

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.

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.

1. 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. Appendix 10 discusses the concept of materiality used in Auditing Standard No. 11.[16]

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.

2. 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. Appendix 10 discusses the concept of materiality in the context of an audit.[17]

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[15] Ibid.

[16] Section V.B. of Appendix 10.

[17] Ibid.

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.

3. 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.[18] Appendix 10 discusses the use of the term "tolerable misstatement" in more detail.[19]

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.

4. 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*. Appendix 10 provides further discussion regarding this requirement.[20]

IAASB and ASB

The ISA and SAS do not have an analogous requirement.

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[18] Paragraph .18 of AU sec. 350, *Audit Sampling*.

[19] Section V.E. of Appendix 10.

[20] Ibid.

5. 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. Appendix 10 provides further discussion regarding consideration of materiality for multi-location engagements.[21]

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.

6. 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. Appendix 10 provides additional discussion regarding materiality from the perspective of a reasonable investor[22] and the reevaluation of materiality.[23]

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[21] Section V.F. of Appendix 10.

[22] Section V.B. of Appendix 10.

[23] Section V.G. of Appendix 10.

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").[24]

1. 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. Appendix 10 provides additional discussion regarding the objective of the standard.[25]

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.

2. 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

[24] 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.

[25] Section VI.B. of Appendix 10.

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. Appendix 10 provides additional discussion regarding performing risk assessment procedures.[26]

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.

3. 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. Appendix 10 provides additional discussion regarding obtaining an understanding of the company and its environment.[27]

IAASB and ASB

The ISAs and SASs do not include an analogous requirement.

4. 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. Appendix 10 provides additional discussion regarding this requirement.[28]

IAASB and ASB

The ISAs and SASs do not include an analogous requirement.

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[26] Section VI.C. of Appendix 10.

[27] Section VI.D. of Appendix 10.

[28] Ibid.

5. 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.[29] The standard also requires engagement team members to discuss how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures.[30] 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.[31] Appendix 10 provides additional discussion regarding these requirements.[32]

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.

6. 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. Appendix 10 provides additional discussion of this requirement.[33]

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.

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[29] Paragraph 12 of Auditing Standard No. 12.

[30] Paragraph 52 of Auditing Standard No. 12.

[31] Paragraph 67 of Auditing Standard No. 12.

[32] Section VI.D, H, and J respectively of Appendix 10.

[33] Section VI.E. of Appendix 10.

7. 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. Appendix 10 provides additional discussion regarding this requirement.[34]

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." Appendix 10 provides additional discussion regarding the auditor's evaluation of an identified control deficiency in the control environment.[35]

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.

8. 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"),

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[34] Section VI.E.2. of Appendix 10.

[35] Ibid.

(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.

Appendix 10 provides additional discussion regarding the company's risk assessment process.[36]

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.

9. 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

[36] Section VI.E.3. of Appendix 10.

select the controls to test, as well as to assess risk and allocate audit effort. Appendix 10 provides additional discussion of this requirement.[37]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

10. 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 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. Appendix 10 provides additional discussion of this requirement.[38]

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.

11. 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

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[37] Section VI.E.4 of Appendix 10.

[38] Section VI.E.5. of Appendix 10.

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. Appendix 10 provides additional discussion of these requirements.[39]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

12. 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[40] 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. Appendix 10 provides additional discussion regarding these requirements.[41]

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.

13. 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

[39] Section VI.E.7. of Appendix 10.

[40] PCAOB Rule 3501, *Definitions of Terms Employed in Section 3, Part 5 of the Rules.*

[41] Section VI.F.2. of Appendix 10.

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.[42]
- Take into account unusual or unexpected differences from the auditor's expectations that are identified while performing analytical procedures as risk assessment procedures.

Appendix 10 provides additional discussion of these requirements.[43]

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.

14. 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

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

[43] Section VI.G. of Appendix 10.

misstatement should continue throughout the audit, including when conditions change. Appendix 10 provides additional discussion of this requirement.[44]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

15. 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.

Appendix 10 provides additional discussion of these requirements.[45]

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

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[44] Section VI.H.2. of Appendix 10.

[45] Section VI.H. of Appendix 10.

members, but those matters identified are less extensive than those required by PCAOB standards.

16. 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. Appendix 10 provides additional discussion of this requirement.[46]

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.

17. 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. Appendix 10 provides additional discussion of this requirement.[47]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

18. 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. Appendix 10 provides additional discussion of these requirements.[48]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

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[46] Section VI.I. of Appendix 10.

[47] Ibid.

[48] Ibid.

19. 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. Appendix 10 provides additional discussion of this requirement.[49]

IAASB and ASB

The ISAs and the proposed SAS do not include an analogous requirement.

20. 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. Appendix 10 provides additional discussion regarding identifying significant accounts and disclosures and relevant assertions.[50]

IAASB and ASB

The ISAs and SASs do not have an analogous requirement.

21. 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." Appendix 10 provides additional discussion regarding the definition of significant risks.[51]

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*

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[49] Section VI.J. of Appendix 10.

[50] Ibid.

[51] Section VI.K. of Appendix 10.

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").

1. 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. Appendix 10 provides additional discussion regarding the objective of the standard.[52]

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.

2. 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. Appendix 10 provides additional discussion of this requirement.[53]

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.

3. 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

[52] Section VII.B. of Appendix 10.

[53] Section VII.C. of Appendix 10.

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. Appendix 10 provides detailed discussions regarding making pervasive changes as an overall response to risks of material misstatement.[54]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

4. 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. Appendix 10 provides additional discussion regarding application of professional skepticism.[55]

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.

5. 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. Appendix 10 provides additional discussions of these requirements.[56]

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[54] Ibid.

[55] Ibid.

[56] Section VII.F.3. of Appendix 10.

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.

6. 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 controls. Appendix 10 provides additional discussion regarding this requirement.[57]

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.

7. 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. Appendix 10 provides additional discussion of this requirement.[58]

IAASB and ASB

The ISAs and the SASs do not include an analogous requirement.

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[57] Section VII.F.4. of Appendix 10.

[58] Section VII.D. of Appendix 10.

8. 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. Appendix 10 provides additional discussion of this requirement.[59]

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.

9. 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. Appendix 10 provides additional discussion of these requirements.[60]

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.

10. 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. Appendix 10 provides additional discussion of this requirement.[61]

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."

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[59] Section VII.F.6. of Appendix 10.

[60] Section VII.F.7. of Appendix 10.

[61] Section VII.G. of Appendix 10.

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.

11. 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.[62] 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.

12. 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. Appendix 10 provides additional discussion regarding timing of substantive procedures.[63]

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.

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[62] The Board has a separate standards-setting project on confirmations.

[63] Section VII.H. of Appendix 10.

13. 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 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. Appendix 10 provides additional discussion of this requirement.[64]

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.

14. 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. Appendix 10 provides additional discussion of this requirement.[65]

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.

15. 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. Appendix 10 provides additional discussion of this requirement.[66]

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[64] Ibid.

[65] Section VII.I. of Appendix 10.

[66] Section VII.J. of Appendix 10.

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").

1. 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.[67] 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. Appendix 10 provides additional discussion of these requirements.[68]

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.

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[67] AU sec. 329.23.

[68] Section VIII.C. of Appendix 10.

2. Evaluating Evidence from Analytical Procedures

PCAOB

Auditing Standard No. 14 contains a requirement, which was adapted from an existing requirement in PCAOB standards,[69] 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. Appendix 10 provides additional discussion of these requirements in Auditing Standard No. 14.[70]

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, including analytical procedures, that are performed during the audit, in the overall review stage, or in both stages, when forming an overall conclusion concerning whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment, indicate a previously unrecognized risk of material misstatement due to fraud.

3. Analytical Procedures Regarding Revenue

PCAOB

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. Appendix 10 provides additional discussion of this requirement.[71]

IAASB

The ISAs state:

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[69] AU sec. 329.23.

[70] Section VIII.C. of Appendix 10.

[71] Ibid.

> 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.

4. 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. Appendix 10 provides additional discussion regarding corroborating management's explanations.[72]

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.

5. 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. Appendix 10 provides additional discussion of this requirement.[73]

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[72] Ibid.

[73] Section VIII.J. of Appendix 10.

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.

6. 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. Appendix 10 provides additional discussion of this requirement.[74]

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.

7. 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. Appendix 10 provides additional discussion of this requirement.[75]

IAASB and ASB

The ISAs and the SASs do not include an analogous requirement.

8. 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

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[74] Section VIII.F. of Appendix 10.

[75] Section VIII.I. of Appendix 10.

if the effect on the financial statement cannot be readily determined. Appendix 10 provides additional discussions of this requirement.[76]

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.

The SASs include a requirement similar to the ISAs' requirement.

9. 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.[77] Appendix 10 provides additional discussion of this requirement.[78]

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.

10. 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. Appendix 10 provides additional discussion of these requirements.[79]

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

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[76] Ibid.

[77] AU sec. 316.79.

[78] Section VIII.K. of Appendix 10.

[79] Section VIII.L. of Appendix 10.

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.

11. Management's Identification of Offsetting Adjusting Entries

PCAOB

If mana{\BB g}ement 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. Appendix 10 provides additional discussion of these requirements.[80]

IAASB and ASB

The ISAs and SASs do not include analogous requirements.

12. 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. Appendix 10 provides additional discussion of this requirement.[81]

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.

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[80] Ibid.

[81] Section VIII.M. of Appendix 10.

1. 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. Appendix 10 provides additional discussion regarding the objective of the standard.[82]

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.

2. 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. Appendix 10 provides additional discussion regarding this requirement.[83]

IAASB and ASB

The ISA states:

> Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further.

The SAS includes a requirement similar to the ISA's requirement.

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[82] Section IX.C. of Appendix 10.

[83] Section IX.E. of Appendix 10.

3. 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. Appendix 10 provides additional discussion of this requirement.[84]

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.

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[84] Section IX.J. of Appendix 10.

PCAOB Release No. 2012-004

Auditing Standard No. 16, Communications with Audit Committees; *Related Amendments to PCAOB Standards; and Transitional Amendments to AU Sec. 380*

PCAOB Release No. 2012-004
August 15, 2012
PCAOB Rulemaking
Docket Matter No. 030

Summary

The Public Company Accounting Oversight Board ("PCAOB" or the "Board") is adopting (i) Auditing Standard No. 16, *Communications with Audit Committees*, that would supersede the Board's interim standards AU sec. 380, *Communication With Audit Committees*, and AU sec. 310, *Appointment of the Independent Auditor*, (ii) transitional amendments to AU sec. 380, and (iii) related amendments to PCAOB standards.

Board Contacts

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* * * * *

I. Introduction

With the passage of the Sarbanes-Oxley Act of 2002 (the "Act") and the establishment of the PCAOB, Congress acknowledged that auditors play an important role in protecting the interests of investors by preparing and issuing informative, accurate, and independent audit reports.[1] The audit committee[2] also plays an important role in protecting the interests of investors by assisting the board of directors in fulfilling its responsibility to a company's shareholders and others to oversee the integrity of a company's accounting and financial reporting processes and audits. The audit committee, among other things, serves as the board of director's principal interface with the company's auditors and

[1] *See* Section 101(a) of the Act, 15 U.S.C. §7211(a); Senate Report No. 107-206, at 5-6 (July 3, 2002).

[2] The term "audit committee," as defined in Auditing Standard No. 16, is a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to a company, the entire board of directors of the company. For audits of nonissuers, if no such committee or board of directors (or equivalent body) exists with respect to the company, the person(s) who oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.

facilitates communications between the company's board of directors, its management, and its independent auditors on significant accounting issues and policies. The roles of auditors and audit committees are critical to the efficiency and integrity of the capital markets.

Both the auditor and the audit committee benefit from a meaningful exchange of information regarding significant risks of material misstatement in the financial statements and other matters that may affect the integrity of the company's financial reports. Communications between the auditor and the audit committee allow the audit committee to be well-informed about accounting and disclosure matters, including the auditor's evaluation of matters that are significant to the financial statements, and to be better able to carry out its oversight role. Communications with the audit committee provide auditors with a forum separate from management to discuss matters about the audit and the company's financial reporting process.

The Board is adopting Auditing Standard No. 16, *Communications with Audit Committees* (the "standard"), and related amendments to improve the audit by enhancing communications between auditors and audit committees. Auditing Standard No. 16 will replace interim standards AU sec. 380, *Communication With Audit Committees* ("AU sec. 380"), and AU sec. 310, *Appointment of the Independent Auditor* ("AU sec. 310"). Adoption of the standard is in the public interest because the standard establishes requirements that enhance the relevance, timeliness, and quality of the communications between the auditor and the audit committee. The enhanced relevance, timeliness, and quality of communications should facilitate audit committees' financial reporting oversight, fostering improved financial reporting, thereby benefitting investors.

Auditing Standard No. 16 is aligned with the requirements of the Act. For many public companies, the Act served to strengthen and expand the role of the audit committee in the financial reporting process. For example, the Act requires that audit committee members of listed companies be independent and that audit committees be responsible for the appointment, compensation, and oversight of the work of the external auditor for the purpose of preparing or issuing an audit report or related work.[3] These requirements place the audit committee at the center of the relationship between management of a public company and its auditor.

Auditing Standard No. 16 is intended to improve the audit[4] by fostering constructive dialogue between the auditor and the audit committee about significant audit and financial statement matters. The standard requires the auditor to communicate certain matters regarding the audit and the financial statements to the audit committee, which should assist the audit committee in fulfilling its oversight responsibilities regarding the financial reporting process. Effective two-way communication between the auditor and the audit committee on such relevant matters also will benefit the auditor in performing an effective audit.

Auditing Standard No. 16 encourages effective two-way communication between the auditor and the audit committee throughout the audit to assist both parties in understanding matters relevant to the audit. Communications that are tailored to the circumstances and informative, rather than "boiler-plate" or

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[3] *See* Section 301 of the Act and Section 10A(m)(2) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §78j-1(m)(2).

[4] For purposes of this release and standard, an audit is either an audit of internal control over financial reporting that is integrated with an audit of financial statements or an audit of financial statements only.

standardized, will enable the auditor and the audit committee to engage in a dialogue that is more likely to benefit both the audit committee, in conducting its oversight responsibilities, and the auditor, in conducting an effective audit. Effective communication between the auditor and the audit committee may involve many forms of communication, such as presentations, charts, written reports, or robust discussions.

AU sec. 380, which became effective in January 1989, indicated that audit committee communications are incidental to the audit and are not required to occur prior to the issuance of the auditor's report. In contrast, Auditing Standard No. 16 recognizes the importance of the auditor's communications with the audit committee in today's business and regulatory environment; therefore, Auditing Standard No. 16 requires the auditor to communicate the audit strategy and results of the audit to the audit committee in a timely manner and prior to the issuance of the auditor's report to provide an opportunity for the audit committee and the auditor to take appropriate action to address the matters communicated.

Timely communications with the audit committee help the auditor improve the audit by, among other things (i) informing the audit committee, which has responsibility for the oversight of financial reporting, about significant matters related to the audit and the financial statements, (ii) enabling the auditor to obtain the audit committee's insights and information about transactions and events, (iii) enabling the auditor to learn about complaints regarding accounting or auditing matters, and (iv) assisting the auditor in gaining a better understanding of the company and its control environment.

Auditing Standard No. 16 generally links the new communication requirements to the results of related audit performance requirements in other PCAOB standards, or the conduct of the audit. The standard does not otherwise impose new performance requirements, other than communications. Because other PCAOB standards already require the auditor to perform procedures underlying the communications required in Auditing Standard No. 16, and the standard primarily requires communication of the results of the auditor's procedures, the Board does not anticipate a significant increase in cost as a result of the implementation of the standard.

Some of the matters to be communicated under Auditing Standard No. 16 relate specifically to matters involving management's preparation of the company's financial statements. In many companies, management might communicate these matters or take the lead on communicating these matters to the audit committee. The PCAOB does not have the authority to require management to communicate to the audit committee. Additionally, certain communications by the auditor are mandated by federal securities laws and Securities and Exchange Commission ("SEC") rules.[5] Therefore, Auditing Standard No. 16 establishes required communications by the auditor to the audit committee but, at the same time, clearly recognizes and acknowledges that management might communicate to the audit committee certain matters related to the company's financial statements. In such circumstances, the auditor does not need to communicate those matters at the same level of detail as management, as long as certain conditions are met, as specified in the standard.

Auditing Standard No. 16 is scalable for audits of companies of various sizes and complexities. A company's size and complexity might affect the risks of misstatements, the audit strategy, and other significant matters that warrant

[5] *See e.g*, Section 10A(k) of the Exchange Act, 15 U.S.C. §78j-1(k); SEC Rule 2-07 of Regulation S-X ("SEC Rule 2-07"), 17 C.F.R. §210.2-07; and Rule 10A-3 under the Exchange Act, 17 C.F.R. §240.10A-3.

the attention of the audit committee. Based on the specific company's circumstances, the standard requires communications only to the extent that the matters are relevant to the audit of the financial statements of the company or of internal control over financial reporting. For example, an auditor of a smaller, less complex company with fewer difficult auditing or financial reporting issues may have fewer matters to communicate than the auditor of a larger, more complex company.

II. Background

On March 29, 2010, the Board proposed a standard, *Communications with Audit Committees* (the "original proposed standard"), to improve the audit by enhancing the relevance and effectiveness of the communications between the auditor and the audit committee.[6] The original proposed standard was informed by, among other things, the increased use of risk-based audit methodologies, the emphasis on judgments and estimates in the financial reporting frameworks and discussions with the Board's Standing Advisory Group ("SAG").[7]

The Board received 35 comment letters on the original proposed standard.[8] Most commenters were supportive of the original proposed standard, although several commenters suggested that additional outreach to stakeholders might be beneficial. The comments were discussed with the SAG on July 15, 2010.[9] Additionally, on September 21, 2010, the Board held a roundtable[10] to obtain insight from additional stakeholders, including investors, audit committee members, auditors, and preparers.[11] The roundtable discussion explored many key issues that commenters had raised in response to the original proposed standard regarding:

i. Communications beneficial to audit committees;
ii. Accounting policies, practices, and estimates;
iii. Effective two-way communication between the auditor and the audit committee;
iv. Balance between written and oral communications;
v. Audit committee responsibilities in the engagement letter;
vi. Management communications; and
vii. Uncorrected misstatements.

To provide all interested parties with an opportunity for additional comments on the topics discussed at the roundtable, the Board reopened the public comment period on the original proposed standard. The Board received nine additional comment letters during this extended comment period.[12]

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[6] *Proposed Auditing Standard Related to Communications with Audit Committees and Related Amendments to Certain PCAOB Auditing Standards*, PCAOB Release No. 2010-001 (March 29, 2010).

[7] The SAG discussed the audit committee communications standard at a number of its meetings, including meetings on: June 21-22, 2004, June 8, 2005, October 5-6, 2005, and October 14-15, 2009.

[8] Comments on the original proposed standard are available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket030Comments.aspx.

[9] A transcript of the portion of the meeting related to the original proposed standard is available at http://pcaobus.org/Rules/Rulemaking/Docket030/Communications_with_Audit_Committees.pdf.

[10] A listing of the roundtable participants is available at http://pcaobus.org/News/Releases/Pages/09162010_RoundtableParticipants.aspx.

[11] A transcript of the roundtable is available at http://pcaobus.org/Rules/Rulemaking/Docket030/Roundtable_Transcript.pdf.

[12] Comments on the original proposed standard are available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket030Comments.aspx.

The original proposed standard was revised in response to comments received in comment letters and at the roundtable, and discussions with the SAG. The Board reproposed the standard for public comment on December 20, 2011 (the "reproposed standard") to seek comment on:[13]

- The revisions to the original proposed standard to align many of the audit committee communication requirements with the auditor performance requirements included in the risk assessment standards, which were adopted subsequent to the issuance of the original proposed standard;
- The applicability of the proposed standard to the audits of brokers and dealers; and
- The addition of the requirement to communicate significant unusual transactions to the audit committee and to communicate the auditor's understanding of the business rationale for such transactions.

The Board received 39 comment letters in response to the reproposed standard.[14] Commenters to the reproposed standard generally were supportive of the changes made to the original proposed standard to enhance the communications between the auditor and the audit committee. Commenters indicated that the changes made enhanced the quality of information exchanged between the auditor and the audit committee. Commenters also indicated that fuller and more relevant communications between the auditor and the audit committee would enable the audit committee to effectively fulfill its oversight responsibilities regarding the financial reporting process, and allow the auditor to perform a more informed, and thus more efficient and effective, audit.

Commenters on the reproposed standard specifically commented on, among other things, the following matters:

- The definition of audit committee in relation to nonissuers without an audit committee or board of directors;
- Management's communication of significant unusual transactions;
- The communication of the auditor's evaluation of the company's ability to continue as a going concern; and
- The application of the standard to the audits of brokers and dealers.

The Board took all comments received during this standard-setting project into consideration in revising the standard. The definition of audit committee was retained substantially in the form as reproposed, with additional clarification provided in Appendix 4 of this release. Auditing Standard No. 16 was revised to acknowledge that management might communicate certain matters related to significant unusual transactions and that the auditor would not have to communicate such matters at the same level of detail as long as certain criteria within the standard are met. Additionally, communication requirements related to the auditor's evaluation of the company's ability to continue as a going

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[13] *Proposed Auditing Standard Related to Communications with Audit Committees; Related Amendments to PCAOB Standards; and Transitional Amendments to AU sec. 380*, PCAOB Release No. 2011-008 (Dec. 20, 2011).

[14] Comments on the reproposed standard are available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket030Comments.aspx.

concern were revised to align the communications more precisely with the auditor's procedures related to such evaluation. Section IV below discusses the application of Auditing Standard No. 16 to the audits of brokers and dealers.

Significant comments received regarding the reproposed standard are addressed in detail in Appendix 4 of this release.

III. Overview of Auditing Standard No. 16

Auditing Standard No. 16 provides a definition of audit committee, retains or enhances existing communication requirements, incorporates certain SEC auditor communication requirements to audit committees, and adds new communication requirements that are generally linked to performance requirements in other PCAOB standards.

For audits of issuers, Auditing Standard No. 16 incorporates the Act's definition of audit committee as a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to the company, then the audit committee is the entire board of directors of the company. For audits of nonissuers, the definition of audit committee contained in Auditing Standard No. 16 provides that if no audit committee or board of directors (or equivalent body) exists with respect to the company, then the audit committee is the person(s) who oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.

AU sec. 310 requires the auditor to establish an understanding with the client regarding the services to be performed. Auditing Standard No. 16 requires the auditor to establish the understanding of the terms of the audit engagement with the audit committee. This requirement aligns the auditing standard with the provision of the Act that requires the audit committee of listed companies to be responsible for the appointment of the external auditor.[15]

Additionally, Auditing Standard No. 16 requires the auditor to record the terms of the engagement in an engagement letter and to have the engagement letter executed by the appropriate party or parties on behalf of the company and determine that the audit committee has acknowledged and agreed to the terms. These requirements are an expansion of the requirement in AU sec. 310 for the auditor to document the understanding in the working papers, preferably through a written communication with the client.

Auditing Standard No. 16 retains many of the communication requirements in AU sec. 380 and also incorporates the SEC communication requirements.[16] The standard improves the current communication requirements of AU sec. 380 by requiring the communications with the audit committee to occur before the issuance of the audit report. Additionally, the standard enhances certain existing auditor communication requirements by requiring the auditor to communicate:

- Certain matters regarding the company's accounting policies, practices, and estimates;
- The auditor's evaluation of the quality of the company's financial reporting;
- Information related to significant unusual transactions, including the business rationale for such transactions; and

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[15] *See* Section 301 of the Act, and Sections 10A(m)(2) of the Exchange Act, 15 U.S.C. §78j-1(m)(2).

[16] *See* Section 10A(k) of the Exchange Act, 15 U.S.C. §78j-1(k) and SEC Rule 2-07(a)(1)-(3).

- The auditor's views regarding significant accounting or auditing matters when the auditor is aware that management consulted with other accountants about such matters and the auditor has identified a concern regarding these matters.

Auditing Standard No. 16 expands the inquiries of the audit committee required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* which requires the auditor to inquire of the audit committee regarding the matters important to the identification and assessment of risks of material misstatement and fraud risks. The additional inquiries in Auditing Standard No. 16 address whether the audit committee is aware of matters relevant to the audit, including, but not limited to, violations or possible violations of laws or regulations.

Additionally, Auditing Standard No. 16 adds new communication requirements that provide the audit committee with additional information about significant aspects of the audit. These communications are generally linked to the results of the audit procedures or the conduct of the audit. Under Auditing Standard No. 16 the auditor would be required to communicate:

- An overview of the overall audit strategy, including timing of the audit, significant risks the auditor identified, and significant changes to the planned audit strategy or identified risks;
- Information about the nature and extent of specialized skill or knowledge needed in the audit, the extent of the planned use of internal auditors, company personnel or other third parties, and other independent public accounting firms, or other persons not employed by the auditor that are involved in the audit;
- The basis for the auditor's determination that he or she can serve as principal auditor, if significant parts of the audit will be performed by other auditors;
- Situations in which the auditor identified a concern regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting;
- Difficult or contentious matters for which the auditor consulted outside the engagement team;
- The auditor's evaluation of going concern;
- Departure from the auditor's standard report; and
- Other matters arising from the audit that are significant to the oversight of the company's financial reporting process, including complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit.

In addition to the communication requirements included in Auditing Standard No. 16, other PCAOB standards and rules that require the auditor to communicate specific matters to the audit committee are referenced in Appendix B to Auditing Standard No. 16.

While the standard establishes certain requirements regarding auditor communications to the audit committee, Auditing Standard No. 16 does not preclude the auditor from providing additional information to the audit committee. Nor does the standard preclude the auditor from responding to audit committee requests for additional information from the auditor.

IV. Audits of Brokers and Dealers

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[17] gave the Board oversight of the audits of brokers and dealers registered with the SEC. In September 2010, the Commission issued interpretive guidance clarifying that the references in Commission rules and staff guidance and in the federal securities laws to generally accepted auditing standards ("GAAS") or to specific standards under GAAS, as they relate to nonissuer brokers or dealers, should continue to be understood to mean the auditing and attestation standards established by the American Institute of Certified Public Accountants ("AICPA"), but noted that it intended to revisit this interpretation in connection with a SEC rulemaking project to update the audit and attestation requirements for brokers and dealers in light of the Dodd-Frank Act.[18] On June 15, 2011, the SEC proposed to amend its rules, including SEC Rule 17a-5 under the Exchange Act, to require, among other things, that audits of brokers' and dealers' financial statements and examinations of reports regarding compliance with SEC requirements be performed in accordance with the standards of the PCAOB.[19]

If the SEC adopts its proposed amendments to SEC Rule 17a-5 or provides other direction that auditors of brokers and dealers are to comply with PCAOB professional standards, the Board's auditing, attestation, quality control, and, where applicable, independence standards would then apply to audits of brokers and dealers as required by Section 17 of the Exchange Act and SEC Rule 17a-5.[20]

Further, if the SEC adopts its proposed amendments to SEC Rule 17a-5 or provides other direction that auditors of brokers and dealers are to comply with PCAOB standards, prior to the effective date of Auditing Standard No. 16,[21] the Board's interim standard, AU sec. 380, would be in effect for audits of brokers and dealers conducted for periods prior to the effective date of Auditing Standard No. 16. The Board's interim standard, AU sec. 380, which was last amended in 1999, indicates that it is not applicable to the audit of a broker or dealer if the broker or dealer does not have an audit committee[22] or is registered with the SEC only because of Section 15(a) of the Exchange Act.[23] Conversely, the auditor communication requirements under GAAS, which are contained in Statement on Auditing Standards ("SAS") 114, *The Auditor's Communication With Those Charged With Governance,* which was issued by the Auditing Standards Board ("ASB") of the AICPA in 2006, are applicable to audits of all brokers

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[17] Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

[18] SEC, *Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers*, Exchange Act Release No. 62991 (Sept. 24, 2010).

[19] SEC, *Broker-Dealer Reports,* Exchange Act Release No. 64676 (June 15, 2011).

[20] 17 C.F.R. § 240.17a-5.

[21] As noted in Section VII of this release, the Board anticipates that Auditing Standard No. 16 will be effective, subject to SEC approval, for audits of fiscal years beginning on or after December 15, 2012.

[22] AU sec. 380.01 states that the communications required by AU sec. 380 are applicable to entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee).

[23] *See* AU sec. 380.01, which states that the communications required by the standard "are applicable to . . . all Securities and Exchange Commission (SEC) engagements." As noted in footnote 2 to AU sec. 380.01, the audits of brokers and dealers do not fall within an SEC engagement as defined in AU sec. 380 if the broker or dealer is registered only because of Section 15(a) of the Exchange Act.

and dealers.[24] Because of this difference in the applicability of the auditor communication standards to the audits of brokers and dealers, there could be a gap in required audit committee communications if the SEC amendments to SEC Rule 17a-5 are adopted and become effective prior to the effective date of Auditing Standard No. 16. To eliminate this gap, the Board is amending AU sec. 380 to delete the current exception for audits of brokers and dealers that do not have an audit committee or are registered with the SEC only because of Section 15(a) of the Exchange Act. The transitional amendment, which is contained in Appendix 2 to this release, would eliminate the above-referenced gap in audit committee communications by making the communication requirements in AU sec. 380 applicable to audits of issuers and brokers and dealers, as those terms are defined in the Act, prior to the effective date of Auditing Standard No. 16.

If PCAOB standards are applicable to audits of brokers and dealers prior to the effective date of Auditing Standard No. 16, the communication requirements under Auditing Standard No. 16 would be applicable to the audits of brokers and dealers upon the effective date of the standard.

V. Emerging Growth Companies

Pursuant to Section 104 of the Jumpstart Our Business Startups Act ("JOBS Act"), any rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of emerging growth companies ("EGCs") (as defined in Section 3(a)(80) of the Exchange Act) unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."[25] Auditing Standard No. 16 is the first auditing standard adopted by the Board subsequent to enactment of the JOBS Act and accordingly is subject to a separate determination by the SEC regarding its applicability to audits of EGCs.

Pursuant to Section 107(b) of the Act, the Board will file Auditing Standard No. 16 for approval by the SEC. The Board will also request that the SEC approve the application of Auditing Standard No. 16, and the related amendments, to the audits of EGCs.

VI. Appendices

Appendix 1 to this release contains the text of Auditing Standard No. 16, *Communications with Audit Committees,* which has three appendices:

(1) Appendix A—Definitions,

(2) Appendix B—Communications with Audit Committees Required by Other PCAOB Rules and Standards, and

(3) Appendix C—Matters Included in the Audit Engagement Letter.

Appendix 2 to this release contains the transitional amendments to AU sec. 380. Appendix 3 to this release contains amendments to other existing PCAOB

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[24] *See* paragraph 1 of SAS 114 which states "[t]his statement . . . establishes standards and provides guidance on the auditor's communication with those charged with governance in relation to an audit of financial statements," and section 5.129 of the *AICPA Audit & Accounting Guide: Brokers and Dealers in Securities* (July 2010), which states, in part: "AU section 380, *The Auditor's Communication with Those Charged with Governance* . . . has been updated for the issuance of SAS No. 114 . . . . AU 380 is applicable to all broker-dealers being audited under GAAS, regardless of their governance structure or size."

[25] Pub. L. No. 112-106, 126 STAT. 306 (April 5, 2012). *See* Section 103(a)(3)(C) of the Act, 15 U.S.C. §7213 (a)(3)(C), as added by Section 104 of the JOBS Act.

standards. Appendix 4 provides additional discussion of Auditing Standard No. 16, the amendments to other PCAOB standards, and comments received on the reproposed standard. Appendix 5 to this release discusses certain significant differences between the objectives and requirements of Auditing Standard No. 16 and the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board of the AICPA. In developing the standard, the Board considered the requirements of the relevant standards of the IAASB and the ASB.

VII. Effective Date

The Board anticipates that the transitional amendments to AU sec. 380 included in Appendix 2 would be effective, subject to SEC approval, for the periods that PCAOB standards become applicable to audits of brokers and dealers, as designated by the SEC upon adoption of its amendments to SEC Rule 17a-5, if such periods precede the effective date of Auditing Standard No. 16.

The Board anticipates that Auditing Standard No. 16 and related amendments, included in Appendices 1 and 3, respectively, will be effective, subject to SEC approval, for audits of fiscal years beginning on or after December 15, 2012.

On the 15th day of August, in the year 2012, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.
/s/ Phoebe W. Brown
Phoebe W. Brown
Secretary

Appendix 1—Auditing Standard No. 16

Communications with Audit Committees

Introduction

1. This standard requires the auditor to communicate with the company's **audit committee**[1] regarding certain matters related to the conduct of an audit[2] and to obtain certain information from the audit committee relevant to the audit. This standard also requires the auditor to establish an understanding of the terms of the audit engagement with the audit committee and to record that understanding in an engagement letter.

2. Other Public Company Accounting Oversight Board ("PCAOB") rules and standards identify additional matters to be communicated to a company's audit committee (see Appendix B). Various laws or regulations also require the auditor to communicate certain matters to the audit committee.[3] The communication requirements of this standard do not modify or replace communications to the audit committee required by such other PCAOB rules and standards, and other laws or regulations. Nothing in this standard precludes the auditor from communicating other matters to the audit committee.

Objectives

3. The objectives of the auditor are to:

a. Communicate to the audit committee the responsibilities of the auditor in relation to the audit and establish an understanding of the terms of the audit engagement with the audit committee;

b. Obtain information from the audit committee relevant to the audit;

c. Communicate to the audit committee an overview of the overall audit strategy and timing of the audit; and

d. Provide the audit committee with timely observations arising from the audit that are significant to the financial reporting process.

Note: "Communicate to," as used in this standard, is meant to encourage effective two-way communication between the auditor and the audit committee throughout the audit to assist in understanding matters relevant to the audit.

Appointment and Retention

Significant Issues Discussed with Management in Connection with the Auditor's Appointment or Retention

4. The auditor should discuss with the audit committee any significant issues that the auditor discussed with management in connection with the

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

[2] For purposes of this standard, an audit is either an audit of internal control over financial reporting that is integrated with an audit of financial statements or an audit of financial statements only.

[3] *See e.g.,* Section 10A(k) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §78j-1(k); Rule 2-07 of Regulation S-X, 17 C.F.R. §210.2-07; and Rule 10A-3 under the Exchange Act, 17 C.F.R. §240.10A-3.

appointment or retention of the auditor, including significant discussions regarding the application of accounting principles and auditing standards.

Establish an Understanding of the Terms of the Audit

5. The auditor should establish an understanding of the terms of the audit engagement with the audit committee. This understanding includes communicating to the audit committee the following:

a. The objective of the audit;

b. The responsibilities of the auditor; and

c. The responsibilities of management.

6. The auditor should record the understanding of the terms of the audit engagement in an engagement letter and provide the engagement letter to the audit committee annually. The auditor should have the engagement letter executed by the appropriate party or parties on behalf of the company.[4] If the appropriate party or parties are other than the audit committee, or its chair on behalf of the audit committee, the auditor should determine that the audit committee has acknowledged and agreed to the terms of the engagement.

Note: Appendix C describes matters that the auditor should include in the engagement letter about the terms of the audit engagement.

7. If the auditor cannot establish an understanding of the terms of the audit engagement with the audit committee, the auditor should decline to accept, continue, or perform the engagement.

Obtaining Information and Communicating the Audit Strategy

Obtaining Information Relevant to the Audit

8. The auditor should inquire of the audit committee about whether it is aware of matters relevant to the audit,[5] including, but not limited to, violations or possible violations of laws or regulations.[6]

Overall Audit Strategy, Timing of the Audit, and Significant Risks

9. The auditor should communicate to the audit committee an overview of the overall audit strategy, including the timing of the audit,[7] and discuss with

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[4] Absent evidence to the contrary, the auditor may rely on the company's identification of the appropriate party or parties to execute the engagement letter.

[5] In addition to this inquiry, paragraphs 5.f. and 54-57 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, describe the auditor's inquiries of the audit committee, or equivalent (or its chair) regarding the audit committee's knowledge of the risks of material misstatement, including fraud risks. These inquiries include, among other things, whether the audit committee is aware of tips or complaints regarding the company's financial reporting.

[6] *See* AU sec. 317, *Illegal Acts by Clients*, for a description of the auditor's responsibilities when a possible illegal act is detected. For audits of issuers, *see also* Section 10A(b) of the Exchange Act, 15 U.S.C. §78j-1(b), and Rule 10A-1 under the Exchange Act, 17 C.F.R. §240.10A-1.

[7] *See* paragraphs 8-9 of Auditing Standard No. 9, *Audit Planning*, for a description of the auditor's responsibilities for establishing an overall audit strategy.

the audit committee the significant risks identified during the auditor's risk assessment procedures.[8]

Note: This overview is intended to provide information about the audit, but not specific details that would compromise the effectiveness of the audit procedures.

10. As part of communicating the overall audit strategy, the auditor should communicate the following matters to the audit committee, if applicable:

a. The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results related to significant risks;[9]

b. The extent to which the auditor plans to use the work of the company's internal auditors in an audit of financial statements;[10]

c. The extent to which the auditor plans to use the work of internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee when performing an audit of internal control over financial reporting;[11]

d. The names, locations, and planned responsibilities[12] of other independent public accounting firms or other persons, who are not employed by the auditor, that perform audit procedures in the current period audit; and

Note: The term "other independent public accounting firms" in the context of this communication includes firms that perform audit procedures in the current period audit regardless of whether they otherwise have any relationship with the auditor.

e. The basis for the auditor's determination that the auditor can serve as principal auditor, if significant parts of the audit are to be performed by other auditors.[13]

11. The auditor should communicate to the audit committee significant changes to the planned audit strategy or the significant risks initially identified and the reasons for such changes.[14]

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[8] Auditing Standard No. 12 requires the auditor to determine whether identified and assessed risks are significant risks. A significant risk is defined as a risk of material misstatement that requires special audit consideration.

[9] *See* paragraph 16 of Auditing Standard No. 9 for the requirement for the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

[10] *See* AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, which describes the auditor's responsibilities related to the work of internal auditors.

[11] *See* 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*, which describe the auditor's responsibilities related to using the work of others in an audit of internal control over financial reporting.

[12] *See* paragraphs 8-14 of Auditing Standard No. 9, which discuss the auditor's responsibilities for determining the audit strategy, audit plan, and extent to which audit procedures should be performed at selected locations or business units involving multi-location engagements.

[13] *See* AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, which discusses the professional judgments the auditor makes in deciding whether the auditor may serve as principal auditor.

[14] *See* paragraph 15 of Auditing Standard No. 9, which discusses changes in audit strategy and the audit plan during the course of the audit.

Results of the Audit

Accounting Policies and Practices, Estimates, and Significant Unusual Transactions

12. The auditor should communicate to the audit committee the following matters:

a. Significant accounting policies and practices.[15]

(1) Management's initial selection of, or changes in, significant accounting policies or the application of such policies in the current period; and

(2) The effect on financial statements or disclosures of significant accounting policies in (i) controversial areas or (ii) areas for which there is a lack of authoritative guidance or consensus, or diversity in practice.

b. **Critical accounting policies and practices**. All critical accounting policies and practices to be used, including:[16]

(1) The reasons certain policies and practices are considered critical; and

(2) How current and anticipated future events might affect the determination of whether certain policies and practices are considered critical.

Note: Critical accounting policies and practices, as defined in Appendix A, are a company's accounting policies and practices that are both most important to the portrayal of the company's financial condition and results, and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain. Critical accounting policies and practices are tailored to specific events in the current year, and the accounting policies and practices that are considered critical might change from year to year.

c. **Critical accounting estimates**.

(1) A description of the process management used to develop critical accounting estimates;[17]

(2) Management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity;[18] and

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[15] *See, e.g.*, Financial Accounting Standards Board Accounting Standards Codification, Topic 235, Notes to Financial Statements, paragraph 235-10-50-1, which requires the entity to disclose a description of all significant accounting policies as an integral part of the financial statements, and paragraph 235-10-50-3, which describes what should be disclosed.

[16] *See also* Section 10A(k) of the Exchange Act, 15 U.S.C. §78j-1(k), and Rule 2-07(a)(1) of Regulation S-X, 17 C.F.R. §210.2-07(a)(1).

[17] *See* AU sec. 342, *Auditing Accounting Estimates*, which discusses the auditor's responsibilities to obtain and evaluate sufficient appropriate audit evidence to support significant accounting estimates in an audit of financial statements.

[18] *Id.*

(3) Any significant changes management made to the processes used to develop critical accounting estimates or significant assumptions, a description of management's reasons for the changes, and the effects of the changes on the financial statements.[19]

d. Significant unusual transactions.

(1) 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;[20] and

(2) The policies and practices management used to account for significant unusual transactions.

Note: As part of its communications to the audit committee, management might communicate some or all of the matters in paragraph 12. If management communicates any of these matters, the auditor does not need to communicate them at the same level of detail as management, as long as the auditor (1) participated in management's discussion with the audit committee, (2) affirmatively confirmed to the audit committee that management has adequately communicated these matters, and (3) with respect to critical accounting policies and practices, identified for the audit committee those accounting policies and practices that the auditor considers critical. The auditor should communicate any omitted or inadequately described matters to the audit committee.

Auditor's Evaluation of the Quality of the Company's Financial Reporting

13. The auditor should communicate to the audit committee the following matters:

a. Qualitative aspects of significant accounting policies and practices.

(1) The results of the auditor's evaluation of, and conclusions about, the qualitative aspects of the company's significant accounting policies and practices, including situations in which the auditor identified bias in management's judgments about the amounts and disclosures in the financial statements;[21] and

(2) The results of the auditor's evaluation of the differences between (i) estimates best supported by the audit evidence and (ii) estimates included in the financial statements, which are individually reasonable, that indicate a possible bias on the part of the company's management.[22]

b. Assessment of critical accounting policies and practices. The auditor's assessment of management's disclosures related to the critical accounting policies and practices, along with any significant

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[19] *Id.*

[20] *See* paragraph 71.g. of Auditing Standard No. 12.

[21] *See* paragraphs 24-27 of Auditing Standard No. 14, *Evaluating Audit Results*, which describe the auditor's responsibilities related to evaluating the qualitative aspects of the company's accounting practices.

[22] *See* paragraph 27 of Auditing Standard No. 14.

modifications to the disclosure of those policies and practices proposed by the auditor that management did not make.

c. Conclusions regarding critical accounting estimates. The basis for the auditor's conclusions regarding the reasonableness of the critical accounting estimates.[23]

d. Significant unusual transactions. The auditor's understanding of the business rationale for significant unusual transactions.[24]

e. Financial statement presentation. The results of the auditor's evaluation of whether the presentation of the financial statements and the related disclosures are in conformity with the applicable financial reporting framework, including the auditor's 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, and the bases of amounts set forth.[25]

f. New accounting pronouncements. Situations in which, as a result of the auditor's procedures, the auditor identified a concern regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting.

g. Alternative accounting treatments. All alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the auditor.[26]

Other Information in Documents Containing Audited Financial Statements

14. When other information is presented in documents containing audited financial statements, the auditor should communicate to the audit committee the auditor's responsibility under PCAOB rules and standards for such information, any related procedures performed, and the results of such procedures.[27]

Difficult or Contentious Matters for which the Auditor Consulted

15. The auditor should communicate to the audit committee matters that are difficult or contentious for which the auditor consulted outside the

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[23] *See* AU sec. 342, which discusses the auditor's responsibilities to obtain and evaluate sufficient appropriate audit evidence to support significant accounting estimates in an audit of financial statements.

[24] *See* paragraph .66 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

[25] *See* paragraphs 30-31 of Auditing Standard No. 14, which describe the auditor's responsibilities related to the evaluation of whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. Other PCAOB standards, such as AU sec. 334, *Related Parties*, and AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, describe the auditor's responsibilities related to evaluation of specific disclosures in financial statements.

[26] *See also* Section 10A(k) of the Exchange Act, 15 U.S.C. §78j-1(k), and Rule 2-07(a)(2) of Regulation S-X, 17 C.F.R. §210.2-07(a)(2).

[27] *See, e.g.*, AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*. In addition to AU sec. 550, discussion of the auditor's consideration of other information is included in AU sec. 558, *Required Supplementary Information*, and AU sec. 711, *Filings Under Federal Securities Statutes*.

engagement team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process.

Management Consultation with Other Accountants

16. When the auditor is aware that management consulted with other accountants about significant auditing or accounting matters and the auditor has identified a concern regarding such matters, the auditor should communicate to the audit committee his or her views about such matters that were the subject of such consultation.

Going Concern

17. The auditor should communicate to the audit committee, when applicable, the following matters relating to the auditor's evaluation of the company's ability to continue as a going concern:[28]

a. If the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the conditions and events that the auditor identified that, when considered in the aggregate, indicate that there is substantial doubt;[29]

b. If the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern is alleviated, the basis for the auditor's conclusion, including elements the auditor identified within management's plans that are significant to overcoming the adverse effects of the conditions and events;[30]

c. If the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time remains:[31]

   (1) The effects, if any, on the financial statements and the adequacy of the related disclosure;[32] and

   (2) The effects on the auditor's report.[33]

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[28] *See* AU sec. 341 for the requirements regarding an auditor's responsibility to evaluate whether there is substantial doubt about a company's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. Additionally, AU secs. 341.03a-c provide the auditor with an overview of the requirements for evaluating whether there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.

[29] *See* AU sec. 341.06, which provides examples of such conditions and events and AU sec. 341.07, which discusses the auditor's procedures if the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.

[30] *See* AU sec. 341.08, which discusses the auditor's responsibilities related to the auditor's evaluation of management's plans.

[31] *See* AU sec. 341.12, which describes the effects on the auditor's report. *See also* AU sec. 341.03c, which discusses the auditor's evaluation of factors that indicate there is substantial doubt about the company's ability to continue as a going concern.

[32] *See* AU sec. 341.10, which discusses the possible effects on the financial statements and the adequacy of the related disclosure.

[33] *See* AU secs. 341.12-.16, which discuss the auditor's consideration of the effects on the auditor's report when the auditor concludes that substantial doubt exists about the company's ability to continue as a going concern for a reasonable period of time.

Uncorrected and Corrected Misstatements

18. The auditor should provide the audit committee with the schedule of uncorrected misstatements related to accounts and disclosures[34] that the auditor presented to management.[35] The auditor should discuss with the audit committee, or determine that management has adequately discussed with the audit committee, the basis for the determination that the uncorrected misstatements were immaterial, including the qualitative factors[36] considered. The auditor also should communicate that uncorrected misstatements or matters underlying those uncorrected misstatements could potentially cause future-period financial statements to be materially misstated, even if the auditor has concluded that the uncorrected misstatements are immaterial to the financial statements under audit.

19. The auditor should communicate to the audit committee those corrected misstatements, other than those that are clearly trivial,[37] related to accounts and disclosures that might not have been detected except through the auditing procedures performed, and discuss with the audit committee the implications that such corrected misstatements might have on the company's financial reporting process.

Material Written Communications

20. The auditor should communicate to the audit committee other material written communications between the auditor and management.[38]

Departure from the Auditor's Standard Report

21. The auditor should communicate to the audit committee the following matters related to the auditor's report:

a. When the auditor expects to modify the opinion in the auditor's report, the reasons for the modification, and the wording of the report; and

b. When the auditor expects to include explanatory language or an explanatory paragraph in the auditor's report, the reasons for the explanatory language or paragraph, and the wording of the explanatory language or paragraph.

Disagreements with Management

22. The auditor should communicate to the audit committee any disagreements with management about matters, whether or not satisfactorily resolved,

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[34] Footnote 13 to paragraph 20 of Auditing Standard No. 14 indicates that misstatements include omission and presentation of inaccurate or incomplete disclosures.

[35] *See* Section 13(i) of the Exchange Act, 15 U.S.C.§78m(i), which states, in part, that financial statements prepared in accordance with generally accepted accounting principles and filed with the Securities and Exchange Commission "shall reflect all material correcting adjustments that have been identified by a registered public accounting firm . . . ."

[36] Appendix B of Auditing Standard No. 14 discusses the qualitative factors related to the evaluation of the materiality of uncorrected misstatements.

[37] *See* paragraph 10 of Auditing Standard No. 14, which requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial.

[38] *See also* Section 10A(k) of the Exchange Act, 15 U.S.C. §78j-1(k) and Rule 2-07(a)(3) of Regulation S-X, 17 C.F.R. §210.2-07 (a)(3).

that individually or in the aggregate could be significant to the company's financial statements or the auditor's report. Disagreements with management do not include differences of opinion based on incomplete facts or preliminary information that are later resolved by the auditor obtaining additional relevant facts or information prior to the issuance of the auditor's report.

Difficulties Encountered in Performing the Audit

23. The auditor should communicate to the audit committee any significant difficulties encountered during the audit. Significant difficulties encountered during the audit include, but are not limited to:

a. Significant delays by management, the unavailability of company personnel, or an unwillingness by management to provide information needed for the auditor to perform his or her audit procedures;

b. An unreasonably brief time within which to complete the audit;

c. Unexpected extensive effort required by the auditor to obtain sufficient appropriate audit evidence;

d. Unreasonable management restrictions encountered by the auditor on the conduct of the audit; and

e. Management's unwillingness to make or extend its assessment of the company's ability to continue as a going concern when requested by the auditor.

Note: Difficulties encountered by the auditor during the audit could represent a scope limitation,[39] which may result in the auditor modifying the auditor's opinion or withdrawing from the engagement.

Other Matters

24. The auditor should communicate to the audit committee other matters arising from the audit that are significant to the oversight of the company's financial reporting process. This communication includes, among other matters, complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit and the results of the auditor's procedures regarding such matters.[40]

Form and Documentation of Communications

25. The auditor should communicate to the audit committee the matters in this standard, either orally or in writing,[41] unless otherwise specified in this standard. The auditor must document the communications in the work papers, whether such communications took place orally or in writing.[42]

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[39] *See* paragraphs .22-.32 of AU sec. 508, *Reports on Audited Financial Statements*, for a discussion of scope limitations.

[40] AU secs. 316.79-.81 and AU sec. 317.17 include specific communication requirements relating to fraud or illegal acts, respectively.

[41] *See* paragraphs .07-.11 of AU sec. 532, *Restricting the Use of an Auditor's Report*, which apply to certain written reports on matters coming to the auditor's attention during the course of the audit.

[42] Consistent with the requirements of Auditing Standard No. 3, *Audit Documentation*, the audit documentation should be in sufficient detail to enable an experienced auditor, having no previous connection with the engagement, to understand the communications made to comply with the provisions of this standard.

Note: If, as part of its communications to the audit committee, management communicated some or all of the matters identified in paragraphs 12 or 18 and, as a result, the auditor did not communicate these matters at the same level of detail as management, the auditor must include a copy of or a summary of management's communications provided to the audit committee in the audit documentation.

Timing

26. All audit committee communications required by this standard should be made in a timely manner and prior to the issuance of the auditor's report.[43] The appropriate timing of a particular communication to the audit committee depends on factors such as the significance of the matters to be communicated and corrective or follow-up action needed, unless other timing requirements are specified by PCAOB rules or standards or the securities laws.

Note: An auditor may communicate to only the audit committee chair if done in order to communicate matters in a timely manner during the audit. The auditor, however, should communicate such matters to the audit committee prior to the issuance of the auditor's report.

[43] Consistent with Rule 2-07 of Regulation S-X, 17 C.F.R. § 210.2- 07, in the case of a registered investment company, audit committee communication should occur annually, and if the annual communication is not within 90 days prior to the filing of the auditor's report, the auditor should provide an update in the 90-day period prior to the filing of the auditor's report, of any changes to the previously reported information.

Appendix A

Definitions

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

A2. Audit committee—A committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to the company, the entire board of directors of the company.

For audits of nonissuers, if no such committee or board of directors (or equivalent body) exists with respect to the company, the person(s) who oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.

A3. Critical accounting estimate—An accounting estimate where (a) the nature of the estimate is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change and (b) the impact of the estimate on financial condition or operating performance is material.

A4. Critical accounting policies and practices—A company's accounting policies and practices that are both most important to the portrayal of the company's financial condition and results, and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.

Appendix B

Communications with Audit Committees Required by Other PCAOB Rules and Standards

This appendix identifies other PCAOB rules and standards related to the audit that require communication of specific matters between the auditor and the audit committee.

- Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, paragraphs 60, 62, and 64
- Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* paragraphs 78-81, 91, C7, and C14
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, paragraphs 5.f. and 54-57
- PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*
- PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting*
- PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*
- AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* paragraphs .79-.81
- AU sec. 317, *Illegal Acts by Clients*, paragraphs .08, .17, and .20
- AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*, paragraphs 4-7 and 9
- AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, paragraph .50
- AU sec. 333, *Management Representations*, paragraph .05
- AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, paragraphs .04 and .06
- AU sec. 711, *Filings Under Federal Securities Statutes*, paragraph .13
- AU sec. 722, *Interim Financial Information*, paragraphs .08-.09, .30-.31, and .33-.36

Appendix C

Matters Included in the Audit Engagement Letter

C1. The auditor should include the following matters in the engagement letter.[1] The auditor's description of these matters will vary depending on whether the auditor is engaged in a financial statement audit or in an audit of internal control over financial reporting that is integrated with an audit of financial statements ("integrated audit").

a. The objective of the audit is:

   1. Integrated audit: The expression of an opinion on both the effectiveness of internal control over financial reporting and the financial statements.

   2. Audit of financial statements: The expression of an opinion on the financial statements.

b. Auditor's responsibilities:

   1. The auditor is responsible for conducting the audit in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that the auditor:

      a. Integrated audit: Plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether effective internal control over financial reporting was maintained in all material respects. Accordingly, there is some risk that a material misstatement of the financial statements or a material weakness in internal control over financial reporting would remain undetected. Although not absolute assurance, reasonable assurance is a high level of assurance.

         Also, an integrated audit is not designed to detect error or fraud that is immaterial to the financial statements or deficiencies in internal control over financial reporting that, individually or in combination, are less severe than a material weakness. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

      b. Audit of financial statements: Plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or

[1] Certain matters should not be included in an engagement letter; for example, under Securities and Exchange Commission, *Section 602.02.f.i. of the Codification of Financial Reporting Policies*, indemnification provisions are not permissible for audits of issuers.

fraud. Accordingly, there is some risk that a material misstatement would remain undetected. Although not absolute assurance, reasonable assurance is a high level of assurance. Also, a financial statement audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

2. An audit includes:

   a. Integrated audit: In fulfillment of the responsibilities noted above, the auditor communicates:

      1. To the audit committee and management: all material weaknesses in internal control over financial reporting identified during the audit, in writing.
      2. To the audit committee: all significant deficiencies identified during the audit, in writing, and informs the audit committee when the auditor has informed management of all internal control deficiencies.
      3. To management: all internal control deficiencies identified during the audit and not previously communicated in writing by the auditor or by others, including internal auditors or others within the company.
      4. To the board of directors: any conclusion that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective, in writing.

   b. Audit of financial statements: Obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed.[2] An audit of financial statements is not designed to provide assurance on internal control or to identify internal control deficiencies. However, the auditor is responsible for communicating:

      1. To the audit committee and management: all significant deficiencies and material weaknesses identified during the audit, in writing.
      2. To the board of directors: if the auditor becomes aware that the oversight of

[2] AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements*, provides direction on control deficiencies identified in an audit of financial statements.

the company's external financial reporting and internal control over financial reporting by the audit committee is ineffective, that conclusion, in writing.

c. Management's responsibilities:
    1. Management is responsible for the company's financial statements, including disclosures.
    2. Management is responsible for establishing and maintaining effective internal control over financial reporting.
    3. Management is responsible for identifying and ensuring that the company complies with the laws and regulations applicable to its activities.
    4. Management is responsible for making all financial records and relevant information available to the auditor.
    5. At the conclusion of the engagement, management will provide the auditor with a letter that confirms certain representations made during the audit.
    6. Management is responsible for adjusting the financial statements to correct material misstatements relating to accounts or disclosures and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

C2. In connection with a review of interim financial information, to confirm and document the understanding, the auditor should either: (a) document in the audit engagement letter the nature and objectives of the engagement to review interim financial information and the responsibilities of management and the auditor or (b) issue a separate engagement letter that addresses such matters.[3]

[3] Paragraphs .08-.09 of AU sec. 722, *Interim Financial Information*, discuss the auditor's responsibilities related to establishing an understanding with the audit committee in connection with a review of the company's interim financial information.

Appendix 2

Transitional Amendments to AU sec. 380, Communication With Audit Committees

Auditing Standard

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:

a. The last sentence of paragraph .01 is replaced with:

> The communications required by this section are applicable to the audits of (i) issuers and (ii) brokers and dealers, as those terms are defined in the Sarbanes-Oxley Act of 2002, as amended.[2]

b. Footnote 2 to paragraph .01 is replaced with:

> *See* Sections 2(a)(7), 110(3), and 110(4) of the Sarbanes-Oxley Act of 2002.

Appendix 3

Amendments to PCAOB Standards

Auditing Standards

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*, as amended, is amended as follows:

a. The following sentence is added at the end of paragraph 80:

> This communication should be made in a timely manner and prior to the issuance of the auditor's report on internal control over financial reporting.

b. The following sentence is added after the first sentence of paragraph 81:

> The auditor should communicate this information to the audit committee in a timely manner and prior to the issuance of the auditor's report on internal control over financial reporting.

Auditing Standard No. 9, *Audit Planning*

Auditing Standard No. 9, *Audit Planning*, is amended as follows:

a. Paragraph 6.c. is replaced with:

> Establish an understanding of the terms of the audit engagement with the audit committee in accordance with Auditing Standard No. 16, *Communications with Audit Committees*.

b. Footnote 4 to paragraph 6 is deleted.

c. In footnote 7 to paragraph 9.a., the references to AU sec. 310 and AU sec. 380, *Communication with Audit Committees*, are replaced with a reference to Auditing Standard No. 16, *Communications with Audit Committees*.

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

Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, is amended as follows:

The note to paragraph 5.d. is deleted.

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 superseded.

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 third sentence of paragraph .79 is replaced with:

> Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to the audit committee in a timely manner and prior to the issuance of the auditor's report.

b. The second sentence of paragraph .81 is replaced with:

> Such a communication may be a part of an overall communication to the audit committee of business and financial statement risks affecting the entity and/or in conjunction with the auditor communication about the qualitative aspects of the entity's accounting policies and practices (see paragraphs 12–13 of Auditing Standard No. 16, *Communications with Audit Committees*). The auditor should communicate these matters to the audit committee in a timely manner and prior to the issuance of the auditor's report.

c. Within footnote 10 to paragraph .88, the reference to section 380, *Communication With Audit Committees*, is replaced with a reference to Auditing Standard No. 16, *Communications with Audit Committees*.

AU sec. 317, "Illegal Acts by Clients"

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

a. The fourth sentence of paragraph .08 is replaced with:

> The auditor should make inquiries of management and the audit committee[1] concerning the client's compliance with laws and regulations and knowledge of violations or possible violations of laws or regulations.

b. Footnote 1 is added to paragraph .08 after the term "audit committee":

> For this standard, audit committee is defined as a committee (or equivalent body) established by and among the board of directors of an entity for the purpose of overseeing the accounting and financial reporting processes of the entity and audits of the financial statements of the entity; if no such committee exists with respect to the entity, the entire board of directors of the entity. For audits of nonissuers, if no such committee or board of directors (or equivalent body) exists with respect to the entity, the person(s) who oversee the accounting and financial reporting processes of the entity and audits of the financial statements of the entity.

c. The first sentence of paragraph .17 is replaced with:

> The auditor should assure himself that the audit committee is adequately informed as soon as practicable and prior to the issuance

of the auditor's report with respect to illegal acts that come to the auditor's attention.

d. Footnote 1 to paragraph .17 is deleted.

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

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

Paragraph .50 is replaced with:

Paragraphs 12-13 of Auditing Standard No. 16, *Communications with Audit Committees*, require the auditor to communicate to the audit committee matters related to critical accounting estimates, which may include fair value measurements.

AU sec. 333, "Management Representations"

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

The following sentence is added as the last sentence of paragraph .05:

The auditor should provide a copy of the representation letter to the audit committee if management has not already provided the representation letter to the audit committee.

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 a 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:

Paragraph .17A is added, along with the heading preceding this paragraph:

Communications with Audit Committees

Paragraph 17 of Auditing Standard No. 16, *Communications with Audit Committees*, describes matters an auditor is required to communicate to the audit committee related to the auditor's evaluation of a company's ability to continue as a going concern for a reasonable period of time.

AU sec. 380, "Communication With Audit Committees"

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

AU sec. 9380, "Communication With Audit Committees: Auditing Interpretations of Section 380"

AU sec. 9380, "Communication With Audit Committees: Auditing Interpretations of Section 380," is superseded.

AU sec. 532, "Restricting the Use of an Auditor's Report"

SAS No. 87, "Restricting the Use of an Auditor's Report (AU sec. 532, "Restricting the Use of an Auditor's Report"), as amended, is amended as follows:

In the second bullet point of paragraph .07, the reference to Section 380, *Communication With Audit Committees*, is replaced with a reference to Auditing Standard No. 16, *Communications with Audit Committees*.

AU sec. 550, "Other Information in Documents Containing Audited Financial Statements"

SAS No. 8, "Other Information in Documents Containing Audited Financial Statements" (AU sec. 550, "Other Information in Documents Containing Audited Financial Statements"), as amended, is amended as follows:

a. The sixth sentence of paragraph .04 is replaced with:

   If the other information is not revised to eliminate the material inconsistency, he should communicate the material inconsistency to the audit committee and consider other actions, such as revising his report to include an explanatory paragraph describing the material inconsistency, withholding the use of his report in the document, and withdrawing from the engagement.

b. The second sentence of paragraph .06 is replaced with:

   He should communicate the material misstatement of fact to the client and the audit committee, in writing, and consider consulting his legal counsel as to further appropriate action in the circumstances.

AU sec. 711, "Filings Under Federal Securities Statutes"

SAS No. 37, "Filings Under Federal Securities Statutes" (AU sec. 711, "Filings Under Federal Securities Statutes"), as amended, is amended as follows:

The last sentence of paragraph .13 is replaced with:

In either case, the accountant should communicate the matter to the audit committee and also consider withholding his consent to the use of his report on the audited financial statements in the registration statement.

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. The heading preceding paragraph .08, "Establishing an Understanding With the Client" is replaced with the heading, "Establishing an Understanding with the Audit Committee."

b. Paragraph .08 is replaced with:

   The accountant should establish an understanding of the terms of an engagement to review interim financial information with the audit committee or others with equivalent authority and responsibility (hereafter referred to as the audit committee).[6] This understanding includes the objective of the review of interim financial information, the responsibilities of the accountant, and the responsibilities

of management. Such an understanding reduces the risk that either the accountant or the audit committee may misinterpret the needs or expectations of the other party. The accountant should record this understanding of the terms of the engagement in an engagement letter and should provide the engagement letter to the audit committee. The accountant should have the engagement letter executed by the appropriate party or parties on behalf of the company. If the appropriate party or parties are other than the audit committee, or its chair on behalf of the audit committee, the accountant should determine that the audit committee has acknowledged and agreed to the terms of the engagement. If the accountant believes he or she cannot establish an understanding of the terms of an engagement to review interim financial information with the audit committee, the accountant should decline to accept, continue, or perform the engagement.

c. Footnote 6 to paragraph .08 is replaced with:

See paragraph .16 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

d. In the first sentence of paragraph .09, the word "client" is replaced with the words "audit committee."

e. Paragraph .30 is replaced with:

If management does not respond appropriately to the accountant's communication within a reasonable period of time, the accountant should communicate these matters to the audit committee as soon as practicable and prior to the registrant filing its periodic report with the SEC. The communications to the audit committee should be made and documented in accordance with paragraph 25 of Auditing Standard No. 16, *Communications with Audit Committees*.

f. The following sentence is added at the end of paragraph .33:

The accountant should communicate significant deficiencies or material weaknesses of which the accountant has become aware to the audit committee or those responsible for oversight of the company's financial reporting in a timely manner and prior to the registrant filing its periodic report with the SEC.

g. Paragraph .34 is replaced with:

When conducting a review of interim financial information, the accountant also should determine whether any of the matters described in Auditing Standard No. 16, *Communications with Audit Committees*, as they relate to interim financial information, have been identified. If such matters have been identified, the accountant should communicate them to the audit committee in a timely manner and prior to the registrant filing its periodic report with the SEC. For example, the accountant should communicate a description of the process management used to develop the critical accounting estimates; a change in a significant accounting policy affecting the interim financial information; misstatements that, either individually or in the aggregate, could have a significant effect on the entity's financial reporting process; and uncorrected misstatements aggregated by the accountant that management determined to be immaterial, both individually and in the aggregate, to the interim financial statements taken as a whole.[23] As part of its communications to the audit committee, management might communicate some or all of the matters related to the company's accounting policies, practices, estimates, and significant unusual transactions described in paragraph 12 of

Auditing Standard No. 16, *Communications with the Audit Committees*. If management communicates any of these matters, the accountant does not need to communicate them at the same level of detail as management, as long as the accountant (1) participated in management's discussion with the audit committee, (2) affirmatively confirmed to the audit committee that management has adequately communicated these matters, and (3) with respect to critical accounting policies and practices, identified for the audit committee those accounting policies and practices that the accountant considers critical. The accountant should communicate any omitted or inadequately described matters to the audit committee.

h. Footnote 23 to paragraph .34 is replaced with:

The schedule of uncorrected misstatements related to accounts and disclosures provided to the audit committee should be the same schedule that was included in or attached to the management representation letter that is described in paragraph .24(*k*) of this section.

i. The last two sentences of paragraph .35 are replaced with:

Therefore, any communication the accountant may make about the entity's accounting policies, practices, estimates, and significant unusual transactions as applied to its interim financial reporting, generally would be limited to the effect of significant events, transactions, and changes in accounting estimates that the accountant considered when conducting the review of interim financial information. Further, interim review procedures do not provide assurance that the accountant will become aware of all matters that might affect the accountant's judgments about the qualitative aspects of the entity's accounting policies and practices that would be identified as a result of an audit.

j. Paragraph .36 is replaced with:

If the accountant has identified matters to be communicated to the audit committee, the accountant should communicate such matters to the audit committee, or at least its chair, in a timely manner and prior to the registrant filing its periodic report with the SEC. The communications to the audit committee should be made and documented in accordance with paragraph 25 of Auditing Standard No. 16, *Communications with Audit Committees*.

Appendix 4

Additional Discussion of Auditing Standard No. 16, Related Amendments to PCAOB Standards, and Comments on the Reproposed Standard

This appendix discusses Auditing Standard No. 16, *Communications with Audit Committees* (the "standard"), presented in Appendix 1, and the related amendments to PCAOB standards in Appendix 3.[1] In particular, this appendix provides additional background information for certain requirements in the standard and related amendments.

The standard was originally proposed on March 29, 2010[2] (the "original proposed standard"), a roundtable was held on September 21, 2010,[3] and the standard was reproposed on December 20, 2011[4] (the "reproposed standard"). This appendix also discusses the Board's responses to significant issues raised by the comments on the reproposed standard, as well as the basis for the Board's conclusions regarding certain requirements.

I. Definition of Audit Committee (Paragraph A-2 of Auditing Standard No. 16)

Auditing Standard No. 16 defines an audit committee as a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to the company, the entire board of directors of the company. This definition largely incorporates the definition of "audit committee" from the Sarbanes-Oxley Act of 2002 (the "Act").[5] The parenthetical phrase "or equivalent body" after the term "committee" clarifies that entities with bodies performing a function similar to that of an audit committee would fit within this category.

The standard modifies the Act's version of the definition of an audit committee as it relates to audits of nonissuers. Specifically, for audits of nonissuers, Auditing Standard No. 16 states that, if no such committee or board of directors (or equivalent body) exists with respect to the company, the audit committee would be considered the person(s) who oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company. This modification was made to recognize that some nonissuers, including brokers and dealers, may have governance structures that do not include boards of directors or audit committees. In those cases, the auditor would identify those

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[1] The transitional amendments to AU sec. 380, *Communication With Audit Committees* ("AU sec. 380"), in Appendix 2 are discussed on pages 12-14 of the release.

[2] *Proposed Auditing Standard Related to Communications with Audit Committees and Related Amendments to Certain PCAOB Auditing Standards*, PCAOB Release No. 2010-001 (March 29, 2010).

[3] A transcript of the roundtable is available at http://pcaobus.org/Rules/Rulemaking/Docket030/Roundtable_Transcript.pdf.

[4] *Proposed Auditing Standard Related to Communications with Audit Committees; Related Amendments to PCAOB Standards; and Transitional Amendments to AU sec. 380*, PCAOB Release No. 2011-008 (Dec. 20, 2011).

[5] Section 2(a)(3) of the Act, 15 U.S.C. § 7201.

persons at the nonissuer company who oversee the company's accounting and financial reporting processes and audits. This modification is meant to indicate that senior persons in an oversight role in such circumstances would be the recipients of the auditor communications.

Using the definition of "audit committee," the auditor would identify the bodies or persons that oversee the company's accounting, auditing, and financial reporting processes to find the appropriate recipient of the communications under the standard.[6] For issuers, the definition is the same as the definition included in the Act.[7] For nonissuers, the definition contains three categories of bodies or persons. The first two categories (audit committee and the entire board of directors of the company) are the same as those included in the definition of audit committee for an issuer. The third category covers situations in which the company does not have an audit committee, board of directors, or equivalent body, such as certain non-public brokers and dealers. The parenthetical phrase "or equivalent body" after the term "board of directors" clarifies that entities with bodies performing a function similar to that of a corporate board of directors would fit within this category.

The reproposed standard required the auditor to communicate to those persons designated to oversee the financial reporting processes of the company in situations in which a nonissuer does not have an audit committee, board of directors, or equivalent body. Some commenters indicated that, for certain nonissuers, the person designated to oversee the accounting and financial reporting processes of the company could be the chief financial officer, in which case the communication would be made to the person preparing the financial statements. Therefore, commenters suggested that the auditor should make relevant communications to the chief executive officer, or equivalent officer of the company.

The definition was revised to focus on the person(s) identified by the auditor as responsible for overseeing the accounting and financial reporting processes of the company. However, the definition was not revised to exclude from the definition of audit committee those persons with oversight responsibility who also have management responsibilities for the preparation of the financial statements of the company. As adopted, for nonissuers with no existing audit committee or board of directors (or equivalent body), the auditor would be expected to identify senior persons at the company who have decision-making authority and responsibility to oversee the accounting and financial reporting processes of the company and audits of the financial statements, and to make the required communications to those persons. For example, in an owner managed entity, the person with oversight of financial reporting within the company could be the owner. Under a limited partnership, the person with oversight of financial reporting within the company could be the managing or general partner responsible for preparation of the financial statements and oversight of the partnership's audits.

Nevertheless, if all persons identified by the auditor as having responsibility for oversight of the company's accounting and financial reporting processes and audits also have management responsibilities for the preparation of the financial statements, then the auditor could also make the communications specified in the standard to other individuals at the company. For example the auditor

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[6] The Board's proposed definition is not intended to conflict with or affect any requirements, or the application of any requirements, under federal law, state law, foreign law, or an entity's governing documents regarding the establishment, approval, or ratification of board of directors or audit committees, or the delegation of responsibilities of such a committee or board.

[7] Section 2(a)(3) of the Act, 15 U.S.C. § 7201.

might identify that the chief executive officer has oversight responsibility for the company's accounting and financial reporting processes; therefore, in those circumstances communications to the chief executive would be in compliance with the audit committee definition in Auditing Standard No. 16. Additionally, the auditor might identify others in charge of the company's operations and performance, who may benefit from the communications.

Some commenters suggested that the standard should clarify to whom the auditor should communicate when the company is a subsidiary of another entity. Auditing Standard No. 16 does not require communication outside the governance structure of the audited entity because the standard designates the appropriate party to receive the auditor communications within the audited entity. If directed by the audit client, or if the auditor otherwise deems it appropriate, the auditor could also communicate to a parent company audit committee or equivalent body.

II. Objectives (Paragraph 3 of Auditing Standard No. 16)

Auditing Standard No. 16 states that the objectives of the auditor are to (a) communicate to the audit committee the responsibilities of the auditor in relation to the audit and establish an understanding of the terms of the audit engagement with the audit committee; (b) obtain information from the audit committee relevant to the audit; (c) communicate to the audit committee an overview of the overall audit strategy and timing of the audit; and (d) provide the audit committee with timely observations arising from the audit that are significant to the financial reporting process. The objectives of the standard are intended to highlight the overall context for the requirements in the standard.

III. Significant Issues Discussed with Management in Connection with the Auditor's Appointment or Retention (Paragraph 4 of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to discuss with the audit committee any significant issues that the auditor discussed with management in connection with the appointment or retention of the auditor, including significant discussions regarding the application of accounting principles and auditing standards. This requirement was retained from AU sec. 380.[8]

This requirement is included in the standard because the audit committee might ask management for its views concerning the appointment or retention of the auditor. Management's views might be influenced by the interaction between the auditor and management and the auditor's evaluations and conclusions regarding the application of accounting principles or auditing standards.

Some commenters suggested that these discussions should include a robust fee discussion or a discussion about the results of the auditor's considerations during the client acceptance and continuance process, such as the auditor's views of the entity's accounting and financial reporting practices or management's integrity. The standard was not revised to include such additional matters because the requirement in the standard specifically addresses the auditor's discussions with management related to accounting and auditing matters in

[8] AU sec. 380.15.

connection with the appointment or retention of the auditor. However, Auditing Standard No. 16 requires the auditor to communicate any matters arising from the audit to the audit committee that the auditor believes are significant to the audit committee's oversight of the company's financial reporting process.[9]

IV. Establish an Understanding of the Terms of the Audit (Paragraphs 5-7 of Auditing Standard No. 16)

Auditing Standard No. 16 includes a specific requirement for the auditor to establish an understanding of the terms of the audit engagement with the audit committee. Having a mutually clear understanding of the terms of the engagement, including the objectives of the audit, the responsibilities of the auditor, and the responsibilities of management in connection with the audit, should benefit both the auditor and the audit committee.

The requirement in Auditing Standard No. 16 is similar to the requirement in AU sec. 310, *Appointment of the Independent Auditor* ("AU sec 310"), which requires the auditor to establish an understanding with the client regarding the services to be performed. However, Auditing Standard No. 16 more specifically requires that the understanding be with the audit committee due to the audit committee's financial reporting and audit oversight role, rather than with the "client," which could be understood to mean others besides the audit committee in certain circumstances.

Auditing Standard No. 16 also requires the auditor to record the understanding of the terms of the audit engagement in an engagement letter. Appendix C of Auditing Standard No. 16 describes matters that should be included in an engagement letter, including the objective of the audit and the responsibilities of the auditor and management. This is an expansion of the requirement in AU sec. 310, which requires the auditor to document the understanding of the engagement in the working papers, preferably through a written communication with the client.

Some commenters indicated that the engagement letter should describe the responsibilities of the audit committee related to the audit. The Board considered this suggestion and did not change the standard to include the responsibilities of the audit committee, as those responsibilities are governed by the rules of other organizations, such as the Securities and Exchange Commission ("SEC") and the national securities exchanges.[10] However, the standard does not prohibit the auditor from including other matters in the engagement letter, as agreed upon by the auditor and the audit committee, so long as those matters are not in violation of other standards or rules, for example, independence requirements.

Auditing Standard No. 16 requires the auditor to provide the engagement letter to the audit committee annually. Additionally, the auditor should have the engagement letter executed by the appropriate party or parties on behalf of the company.[11] The standard also states that if the appropriate party or parties are other than the audit committee, or its chair on behalf of the audit committee, the auditor also should determine that the audit committee has acknowledged

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[9] Paragraph 24 of Auditing Standard No. 16.

[10] *See, e.g.,* New York Stock Exchange, Listed Company Manual at Section 303A.07, Audit Committee Additional Requirements.

[11] Absent evidence to the contrary, the auditor may rely on the company's identification of the appropriate party or parties to execute the engagement letter.

and agreed to the terms of the engagement. This acknowledgment may be obtained in a variety of ways, such as obtaining the audit committee members' signatures, or its chair's signature on behalf of the audit committee, or obtaining another form of acknowledgement and agreement by the audit committee regarding the terms of the audit engagement. Obtaining this acknowledgement reduces the risk that either the auditor or the audit committee might misinterpret the needs or expectations of the other party. An acknowledgement by the audit committee, the signatures of the audit committee members, or the signature of its chair on behalf of the audit committee on the engagement letter is not intended to conflict with or affect any requirements, or the application of any requirements, under federal law, state law, foreign law, applicable exchange requirements, or the company's governing documents, regarding the authority or lack of authority of the audit committee to enter into any contract or agreement with the auditor.

Several commenters suggested that the standard should specify that the engagement letter should be executed by management in addition to the audit committee or by management alone, along with a representation that it has the authority to do so on behalf of the audit committee. The Board considered these comments and decided that, absent evidence to the contrary, the auditor may rely on the company's identification of the appropriate party or parties to execute the engagement letter. Therefore, the standard does not specify the party that should execute the engagement letter on behalf of the company.

Some commenters suggested that the standard should indicate that the audit committee's acknowledgement can be either written or oral. Other commenters suggested that the audit committee's acknowledgement should be written, either evidenced by a signature on the engagement letter or in the audit committee's minutes, to avoid the potential for subsequent misunderstandings of whether the audit committee's acknowledgement has been obtained.

The Board considered these comments and determined that the audit committee's acknowledgement may be provided in writing, such as a signed engagement letter or through the minutes of the audit committee meeting, or orally. The primary focus of this requirement is that the auditor receives acknowledgment and agreement from the audit committee rather than the method the audit committee uses to provide that acknowledgement; therefore, a change to the standard was not warranted. The reproposed standard did not specify the form of acknowledgment and, therefore, the standard was not revised. However, the auditor could request that the audit committee acknowledge the terms of the audit engagement in writing. If the audit committee's acknowledgement is received orally, in accordance with paragraph 25 of Auditing Standard No. 16, the auditor is required to document the acknowledgement in the auditor's work papers.

V. Obtaining Information Relevant to the Audit (Paragraph 8 of Auditing Standard No. 16)

Auditing Standard No. 16 includes a requirement for the auditor to inquire of the audit committee about whether it is aware of matters relevant to the audit, including, but not limited to, violations or possible violations of laws or regulations. This inquiry contributes to a two-way dialogue between the auditor and the audit committee concerning matters relevant to the audit. This inquiry would complement the requirement for the auditor to make inquiries of the audit committee (or its chair) about risks of material misstatement, including inquiries related to fraud risks, in accordance with Auditing Standard No. 12,

Identifying and Assessing Risks of Material Misstatement.[12] This requirement is included in the standard because, in addition to the inquiries required as part of the risk assessment procedures, audit committees may be aware of other matters relevant to the auditor in performing audit procedures.

Auditing Standard No. 16 does not include the reference to "complaints or concerns received by the audit committee regarding financial reporting matters" previously included in the reproposed standard. This change is not intended to signal a change in the scope of this communication between the audit committee and the auditor. Rather, the Board notes that such inquiry by the auditor of the audit committee is already included in paragraph 56.b(3) of Auditing Standard No. 12, which requires the auditor to inquire of the audit committee about tips or complaints regarding the company's financial reporting.[13] Since the inquiry in the reproposed standard was similar to the inquiries in Auditing Standard No. 12, Auditing Standard No. 16 was revised to remove the inquiry regarding complaints or concerns.

Auditing Standard No. 16 does not provide specific timing for these inquiries to be made. Depending on the circumstances of the audit, it may be appropriate for the auditor to conduct such inquiries of the audit committee at the outset of the audit and/or at other various stages of the audit. For example, the auditor may want to conduct these inquiries early in the audit to consider any information received from the audit committee in designing the nature, timing, and extent of audit procedures. In other circumstances, as the audit progresses, an auditor may want to inquire of the audit committee as to whether any additional matters or concerns relevant to the audit have come to the attention of the audit committee not previously discussed with the auditor.

The reproposed standard required the auditor to inquire of the audit committee about "whether it is aware of matters that might be relevant to the audit." One commenter raised concerns about this provision of the reproposed standard as being "too broad and overreaching," which could obscure information that is truly relevant to the audit. Other commenters suggested that the inquiries of the audit committee should be expanded to include other matters, such as the audit committee's awareness of significant changes in company conditions or activities.

After considering the comments received on the scope of the information to be communicated under this provision, the term "might be" was excluded from this paragraph of the standard. The deletion of the term "might be" is appropriate to avoid an overly broad interpretation of the standard to require discussion of matters that may not be directly connected to the audit.

Although the Board did not revise the requirement to list all the matters of which the auditor could inquire in this provision, the requirement in the standard is not meant to be limited only to matters that are related to violations or possible violations of laws. The Board did not consider it practical to revise the requirement in an attempt to list all the matters of which the auditor could inquire in this provision. Such matters can and should vary from audit to audit. Rather, the inclusion of such matters was meant to serve only as an example of a matter that the auditor should discuss with the audit committee.

The same commenter who objected to the breadth of the inquiry also raised concerns related to the audit committee providing information to the auditor

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[12] *See* paragraph 5.f. and 54-57 of Auditing Standard No. 12.

[13] Auditing Standard No. 12 also includes inquiries regarding the audit committee's views about fraud risks, its knowledge of fraud, and the audit committee's response to tips or complaints regarding the company's financial reporting, and how the audit committee exercises oversight of the company's assessment of fraud risks. *See* paragraphs 56.b(1)-(4) of Auditing Standard No. 12.

about violations or possible violations of laws or regulations and complaints or concerns received regarding financial reporting matters contained in the reproposed standard. The commenter indicated that the audit committee's communication of such information could cause the information to lose its confidentiality status with potential significant harmful consequences to the company, such as reducing the candor and chilling communications between management, employees, and the audit committee. The commenter also indicated that if the audit committee discloses information covered by privileged attorney-client communications or attorney work product to the auditor as part of this communication, the company may face a risk that a court may later deem the company to have waived the protection of such privilege or work product doctrine.

The Board did not change the requirement to exclude inquiries regarding violations or possible violations of laws or regulations that are relevant to the audit. Limiting the scope of information that the audit committee might provide to the auditor could severely affect the auditor's ability to conduct an effective audit.

The purpose of this requirement is to enable the auditor to have the information necessary to conduct the audit to support the auditor's opinion on the company's financial statements. Due to the audit committee's oversight responsibilities, it is appropriate for the auditor to ask the audit committee for information relevant to the audit, including matters related to violations or possible violations of laws or regulations. Without such inquiry, the auditor may not have information that could influence the performance of the audit.

The same commenter also indicated that if the audit committee provides information relevant to the audit, the audit committee's role would change fundamentally from overseeing the accounting and financial reporting process of the company and audits of financial statements to becoming the original source of information for the auditor and guarantor of the accuracy and completeness of the financial statements, a role that historically has been that of management. It is possible, that in some situations, the communication from the audit committee is the first instance in which a matter is brought to the attention of the auditor. For example, in some situations the audit committee may have unique insight into management's performance. By providing the opportunity for the audit committee to discuss information with the auditor, the standard enables the auditor to obtain the audit committee's perspective on matters which may be different from management's perspective.

VI. Overall Audit Strategy, Timing of the Audit, and Significant Risks (Paragraphs 9-11 of Auditing Standard No. 16)

Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee an overview of the overall audit strategy, including the timing of the audit, and to discuss with the audit committee the significant risks[14] identified during the auditor's risk assessment procedures. Under this requirement, the auditor communicates to the audit committee the results of audit procedures performed in accordance with other PCAOB standards, such as Auditing Standard No. 9, *Audit Planning,* which 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. As part of the auditor's

[14] *See* paragraph A5 of Auditing Standard No. 12, which defines significant risk as a risk of material misstatement that requires special audit consideration.

risk assessment process, the auditor is required to identify and assess the risk of material misstatement, including significant risks.[15]

The timing of communications related to the audit strategy may vary from audit to audit based on the facts and circumstances. However, early communication of these matters might enable the audit committee to understand the auditor's views regarding risk and thereby provide an opportunity for the audit committee to communicate insights regarding additional risks that the auditor did not identify and allow the auditor to more effectively incorporate the additional risks into the audit strategy.

Some commenters indicated that the requirement for the auditor to communicate the audit strategy might result in the audit committee second guessing the auditor's strategy and the scope of the audit. These commenters suggested that the standard should emphasize that the auditor should not disclose details about the audit strategy that would allow management or the audit committee to take steps that could reduce the effectiveness of the audit strategy. Another commenter suggested the standard should require the auditor to provide specific details about the type and timing of procedures. Auditing Standard No. 16 includes a note, which indicates that the overview of the audit strategy is intended to provide information about the audit, but not specific details that would compromise the effectiveness of the audit procedures. Communicating certain details might reduce the effectiveness of those audit procedures. The Board considers that the language in Auditing Standard No. 16 strikes the appropriate balance; therefore, the standard was not revised.

Some commenters suggested that significant risks should be communicated throughout the audit rather than communicating just those significant risks identified during the auditor's risk assessment procedures. It is not the intent of the standard for the auditor to communicate only the significant risks that are identified during the auditor's risk assessment procedures. Paragraph 11 of Auditing Standard No. 16 requires the auditor to communicate significant changes to the planned audit strategy or the significant risks initially identified and the reasons for such changes.

A commenter suggested that the communication of risks be expanded to include business risks and the auditor's views of the company's internal controls, in addition to the significant risks of material misstatement to the financial statements. As part of obtaining an understanding of the company and its environment, Auditing Standard No. 12 requires the auditor to obtain an understanding of the company's objectives, strategies, and related business risks that could reasonably be expected to result in risks of material misstatement.[16] Under Auditing Standard No. 16, the auditor is required to communicate significant risks to the audit committee. If the auditor determines that a business risk results in a significant risk of material misstatement, the auditor should communicate the significant risk to the audit committee. Additionally, under Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* and AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements,* the auditor is required to communicate to the audit committee material weaknesses and significant deficiencies in internal control over financial reporting identified during the audit.[17] Therefore, the standard was not revised.

Auditing Standard No. 16 also requires communications regarding others involved in the audit, such as persons with specialized skill or knowledge, internal

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[15] *See* paragraphs 59, 70, and 71 of the Auditing Standard No. 12.

[16] *See* paragraph 14 of Auditing Standard No. 12.

[17] *See* paragraphs 78 and 80 of Auditing Standard No. 5 and paragraph 4 of AU sec. 325.

audit, and other firms or persons performing audit procedures. Communications of others involved in the audit might be important for an audit committee to understand as part of the audit committee's oversight of the financial reporting process.

A. Specialized Skill or Knowledge (Paragraph 10.a. of Auditing Standard No. 16)

Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee the nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results related to significant risks. This requirement is designed for the auditor to communicate the determination the auditor is required to make as part of developing the audit strategy in Auditing Standard No. 9.[18] Many audit firms have employees with specialized skill or knowledge that the engagement team can utilize. However, other firms might not have such in-house expertise. The focus of this requirement is on the communication about the need for specialized skill or knowledge, regardless of whether the specialist is from within the firm or outside the firm.

B. Internal Audit (Paragraphs 10.b. and 10.c. of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to communicate to the audit committee the extent to which the auditor plans to use the work of the company's internal auditors in an audit of financial statements, including when internal audit provides direct assistance to the auditor. In addition, Auditing Standard No. 16 requires the auditor to communicate the extent to which the auditor plans to use the work of internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee when performing an audit of internal control over financial reporting.

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, including the nature, timing, and extent of resources necessary to perform the engagement.[19] Other standards, including AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, and Auditing Standard No. 5, provide additional requirements and impose limits on the use of internal audit staff. The requirement in Auditing Standard No. 16 is to communicate to the audit committee the extent to which the auditor plans to use the work of the company's internal auditors and others as determined in the audit plan.

C. Other Firms or Persons Performing Audit Procedures (Paragraph 10.d. of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to communicate to the audit committee the names, locations, and planned responsibilities of other independent public accounting firms or other persons, who are not employed

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[18] *See* paragraph 16 of Auditing Standard No. 9 for the requirement for the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

[19] *See* paragraphs 8-9 of Auditing Standard No. 9.

by the auditor, that perform audit procedures in the current period audit. The standard includes a note stating the term "other independent public accounting firms" includes firms that perform audit procedures in the current period audit regardless of whether they otherwise have any relationship with the auditor.

In planning and performing the audit, the auditor determines whether to use other auditors or other persons to perform audit procedures at individual client locations, business units, or to perform work related to specific audit areas or procedures. Those other auditors might be affiliated firms, non-affiliated firms, or other persons not employed by the auditor.

The note to Auditing Standard No. 16 was revised from the reproposed standard to clarify that the communication regarding other independent public accounting firms is not based on the type of relationship the auditor otherwise has with the other firms. Rather, the requirement for the auditor to communicate the names, locations, and planned responsibilities of other independent public accounting firms and other persons is to provide information to the audit committee regarding the parties involved in the audit. This requirement also might facilitate a discussion of how the work of other parties would affect the audit.

The reproposed standard also required the auditor to communicate to the audit committee the "planned roles" of others involved in the audit and the "scope of audit procedures." One commenter suggested that the requirement to communicate the "scope of audit procedures" should be clarified in the standard. Another commenter suggested that the communication should be expanded to be more robust when other participants are used to audit foreign components of a company. Auditing Standard No. 10, *Supervision of the Audit Engagement,* requires the auditor to inform engagement team members of their responsibilities[20] and AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, discusses situations in which the auditor uses the work and reports of other independent auditors who have audited financial statements of one or more subsidiaries, divisions, branches, components or investments included in the financial statements.[21] To align with these requirements, the standard was revised to require the auditor to communicate only the "planned responsibilities" of other participants involved in the audit, the requirements to communicate the "planned roles" of others involved in the audit and the "scope of audit procedures" were removed from the standard, and the standard was not expanded to include other considerations.

Many commenters suggested that the standard provide a threshold for determining when to make communications regarding others involved in the audit, such as when another auditor performs procedures related to a percentage of the company's total assets or addresses significant risks. Others suggested that the communication include only non-affiliated accounting firms. The standard was not revised because audit committees have oversight of the entire audit engagement, which includes work performed by other auditors. The audit committee should be aware of all the participants in the audit. This communication regarding other participants in the audit would enable the audit committee to inquire or otherwise determine, for example, whether the other participants are registered with the Board and are subject to PCAOB inspections and whether they have disciplinary history with the Board or other regulators.

This communication requirement is intended to be scalable. For example, the amount of detail the auditor generally would communicate to the audit committee regarding the participation of other auditors would be greater for

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[20] *See* paragraph 5.a. of Auditing Standard No. 10.

[21] *See* AU sec. 543.01.

participants that perform a significant portion of the audit or that perform procedures related to significant risks.

D. Principal Auditor (Paragraph 10.e. of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to communicate to the audit committee the basis for the auditor's determination that the auditor can serve as principal auditor, if significant parts of the audit are to be performed by other auditors. This communication requirement is based on the auditor's determination that the auditor can serve as the principal auditor in accordance with AU sec. 543. This communication would enable the audit committee to evaluate the extent of work performed by the principal auditor in relation to work performed by other auditors.

The reproposed standard included a note to describe situations where such communications would be required. The Board determined that this note was not necessary because AU sec. 543, governs the determination of whether the auditor can serve as the principal auditor.

VII. Accounting Policies and Practices, Estimates, and Significant Unusual Transactions (Paragraph 12 of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to communicate to the audit committee certain matters related to the company's accounting policies and practices, estimates, and significant unusual transactions. However, the standard recognizes that management also might make communications to the audit committee regarding these matters and that the auditor might not need to communicate the information at the same level of detail as management as long as the auditor meets certain criteria specified in the standard. In such circumstances, the auditor should communicate any omitted or inadequately described matters to the audit committee.

A. Accounting Policies and Practices (Paragraphs 12.a. and 12.b. of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to communicate to the audit committee certain information regarding the company's significant accounting policies and practices and also critical accounting policies and practices.

The standard uses the terms "significant accounting policies and practices" and "critical accounting policies and practices." The Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") and the International Accounting Standards Board ("IASB"), require that companies disclose a description of all significant accounting policies as an integral part of the financial statements.[22] For example, the FASB ASC recognizes that an

[22] *See* FASB ASC, Topic 235, Notes to Financial Statements, section 235-10-50. As part of this disclosure, the entity is required to disclose accounting policies and to describe the accounting principles followed by the entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. Additionally, *see* paragraph 117 of International Accounting Standard 1, *Presentation of Financial Statements*, which requires the entity to disclose the summary of significant accounting policies, including the measurement basis used in preparing the financial statements and other accounting policies that are relevant to understanding the financial statements.

entity's description of its significant accounting policies is an integral part of the financial statements.[23] Additionally, the term "significant accounting policies and practices" is consistent with the term used in AU sec. 380 and understood in practice and, therefore, has not been separately defined.

The definition of "critical accounting policies and practices" in Auditing Standard No. 16 is based on the SEC's description of the term "critical accounting policies and practices" as a company's accounting policies and practices that are both most important to the portrayal of the company's financial condition and results and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.[24] The selection of significant accounting policies and practices involves a broader range of transactions and events over time, while the selection of critical accounting policies and practices is tailored to specific events in the current year. Therefore, critical accounting policies and practices might be viewed as a subset of significant accounting policies and practices.

1. Significant Accounting Policies and Practices (Paragraph 12.a. of Auditing Standard No. 16)

Auditing Standard No. 16 generally retains the requirements from AU sec. 380 related to communication of the company's significant accounting policies and practices, including:

- Management's initial selection of, or changes in, significant accounting policies or the application of such policies in the current period; and
- The effect on financial statements or disclosures of significant accounting policies in (i) controversial areas or (ii) areas for which there is a lack of authoritative guidance or consensus, or diversity in practice.

Auditing Standard No. 16 requires the auditor to communicate to the audit committee certain matters related to significant accounting policies and practices, whereas, AU sec. 380 required the auditor only to determine that the audit committee was "informed." This change in wording is intended to indicate that the auditor should make these communications, rather than determine that the audit committee was informed, as required in AU sec. 380. However, the note to paragraph 12 of Auditing Standard No. 16 acknowledges that such communications may be made by management, and if the auditor meets certain conditions, these communications need not be duplicated by the auditor.

Some commenters suggested that it was unclear whether the communication of the initial selection of, or changes in, significant accounting policies or the application of such policies in the current period would require communication annually if there is no change. Another commenter indicated that the auditor may not be in a position to provide information on areas for which there is diversity in practice because the auditor may not be knowledgeable of accounting practices used by other entities.

Auditing Standard No. 16 was not revised in response to these comments. The standard indicates that the auditor should communicate to the audit committee the initial selection in the current period of significant accounting policies. The standard also indicates that the auditor should communicate to the audit

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[23] *See* FASB ASC paragraphs 235-10-50-1 through 235-10-50-6.

[24] *See* SEC, *Strengthening the Commission's Requirements Regarding Auditor Independence*, Securities Act Release No. 8183 (Jan. 28, 2003).

committee changes in those policies or changes in the application of those policies in the current period if they differ from those policies that management previously utilized or how they were previously applied.

Additionally, the auditor's responsibility to communicate the effect of significant accounting policies includes (i) controversial areas or (ii) areas for which there is lack of authoritative guidance or consensus, or diversity in practice. The auditor should be aware of diversity in practice related to significant accounting policies and practices used by the company because Auditing Standard No. 12 requires the auditor to evaluate whether the company's selection of 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.[25] Based on this evaluation, the auditor should be in a position to make such communication.

2. Critical Accounting Policies and Practices (Paragraph 12.b. of Auditing Standard No. 16)

Auditing Standard No. 16 incorporates the Securities Exchange Act of 1934's ("Exchange Act") requirement for the auditor to communicate to the audit committee all critical accounting policies and practices to be used.[26] Auditing Standard No. 16 also requires the auditor to communicate the reasons certain accounting policies and practices are considered critical and how current and anticipated future events might affect the determination of whether certain policies and practices are considered critical.[27]

Some commenters recommended deleting the requirement for the auditor to communicate how anticipated future events might affect the determination of whether certain policies and practices are considered critical since the auditor cannot predict the future. The standard retains the SEC requirement regarding communication of anticipated future events related to critical accounting policies and practices, as this is a component of the required communication the SEC identified in adopting SEC Rule 2-07.[28] The standard notes that critical accounting policies and practices are tailored to specific events in the current year and that the accounting policies and practices that are considered critical might change from year to year. For example, a significant merger or acquisition may result in the related accounting policy being considered critical in the current year in which the related transaction occurs, but not in subsequent years. Auditing Standard No. 16 is aligned with the SEC requirement, therefore the standard was not revised.

B. Critical Accounting Estimates (Paragraph 12.c. of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to communicate the following matters related to critical accounting estimates:

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[25] Paragraph 12 of Auditing Standard No. 12.

[26] Section 10A(k) of the Exchange Act, 15 U.S.C. § 78j-1(k), requires the auditor to report this information to the audit committee. *See also* SEC Rule 2-07 of Regulation S-X ("SEC Rule 2-07"), 17 C.F.R. §210.2-07.

[27] *See* Securities Act Release No. 8183, which describes the SEC's expectations regarding the discussion related to critical accounting policies and practices. In this release, the SEC indicated that it anticipated that the discussion of accounting policies and practices would include how current and anticipated future events might affect the determination of whether certain policies and practices are considered critical.

[28] *Id.*

(1) A description of the process management used to develop critical accounting estimates;

(2) Management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity; and

(3) Any significant changes management made to the processes used to develop critical accounting estimates or significant assumptions, a description of management's reasons for the changes, and the effects of the changes on the financial statements.

As the term "critical accounting estimate" implies, the communication is not designed to encompass a long list of accounting estimates resulting from the application of accounting policies that cover a substantial number of line items in the company's financial statements. Rather, Auditing Standard No. 16 defines the term "critical accounting estimate" as an accounting estimate where (a) the nature of the estimate is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change and (b) the impact of the estimate on financial condition or operating performance is material.

The definition of "critical accounting estimate" is based on SEC interpretive guidance in connection with management's discussion and analysis ("MD&A") of the company's financial condition and results of operations.[29] The alignment of the term critical accounting estimates in PCAOB standards with the same term in the SEC's interpretive guidance allows auditors to use the same concept under SEC requirements and PCAOB standards when communicating matters to the audit committee. The term critical accounting estimate is used to help focus the communication to the audit committee on those estimates that might be subject to a higher risk of material misstatement, such as certain fair value estimates. The definition of a critical accounting estimate is intended to replace the term "particularly sensitive" in AU sec. 380.[30]

The requirement to communicate the process management used to develop critical accounting estimates is adapted from the requirement in AU sec. 380 related to particularly sensitive accounting estimates.[31] Additionally, the communication requirements are designed to communicate the results of the auditor's performance requirements under AU sec. 342, *Auditing Accounting Estimates*, which requires the auditor to evaluate the reasonableness of accounting estimates. In evaluating the reasonableness of the accounting estimate, AU sec. 342 also requires the auditor to obtain an understanding of how management developed the estimate.[32] AU sec. 342 also states that in evaluating the reasonableness of an estimate, the auditor normally concentrates on key factors and assumptions that are (a) significant to the accounting estimate, (b) sensitive to variations, (c) deviations from historical patterns, and (d) subjective and susceptible to misstatement and bias.[33]

One commenter suggested that the communication requirement also include how management subsequently monitors critical accounting estimates and, when critical accounting estimates involve a range of possible outcomes, how the recorded estimates relate to the range and how various selections within

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[29] *See* SEC, *Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations,* Securities Act Release No. 8350 (Dec. 19, 2003).

[30] *See* AU sec. 380.08, which stated in part, "[c]ertain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments."

[31] AU sec. 380.08.

[32] *See* AU sec. 342.10.

[33] *See* AU Sec. 342.09.

the range would affect the company's financial statements. Although these requirements are not included in Auditing Standard No. 16, the Board notes that the SEC has stated that management should disclose the company's critical accounting estimates in MD&A.[34] According to the related SEC release, management's discussion should present, among other matters, the company's analysis of the uncertainties involved in applying a principle at a given time or the variability that is reasonably likely to result from its application over time and analyze an estimate's specific sensitivity to change based on other outcomes that are reasonably likely to occur and would have a material effect.[35] The commenter's concerns, therefore, may be addressed through a company's MD&A disclosures.

AU sec. 550, *Other Information in Documents Containing Audited Financial Statements,* requires the auditor to read the other information, such as MD&A in documents containing audited financial statements, and consider whether the information, or the manner of its presentation, is materially inconsistent with information in the financial statements or is a material misstatement of fact.[36] Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee the results of such procedures (see Section IX of this appendix, "Other Information in Documents Containing Audited Financial Statements," for further discussion). Accordingly, no change was made to the standard.

C. Significant Unusual Transactions (Paragraph 12.d. of Auditing Standard No. 16)

Auditing Standard No. 16 includes requirements for the auditor to communicate to the audit committee (1) 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;[37] and (2) the policies and practices management used to account for significant unusual transactions. Communication of significant unusual transactions would enable the audit committee to gain the auditor's insight into those transactions and to take any appropriate action.

The requirement in the standard for the auditor to communicate the policies and practices management used to account for significant unusual transactions is similar to the requirement in AU sec. 380.[38] Under Auditing Standard No. 16, such communication also would include the identification of significant unusual transactions.

The reproposed standard required the auditor to communicate significant unusual transactions, of which the auditor is aware, that are outside the normal course of business for the company or otherwise appear to be unusual due to their timing, size, or nature. Many commenters indicated that management also might communicate matters related to significant unusual transactions to the audit committee and that the standard should acknowledge that management might make the communications related to significant unusual transactions. The standard was revised to recognize that management might make these communications to the audit committee and that, in those situations, the auditor might not need to communicate the information at the same level of detail as

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[34] *See* Securities Act Release No. 8350.

[35] *Id.*

[36] AU secs. 550.04-.05.

[37] *See* paragraph 71.g. of Auditing Standard No. 12.

[38] AU sec. 380.07.

management as long as certain criteria specified in the standard are met. However, the auditor should communicate any omitted or inadequately described matters to the audit committee.

Additionally, some commenters suggested that the communication should be limited to significant unusual transactions that are considered significant risks. While a significant unusual transaction might also be considered a significant risk, this communication provides the audit committee with additional information regarding the significant unusual transactions and the policies and practices management used to account for such transactions, even if such transactions do not constitute significant risks. Significant unusual transactions, at times, have been considered to be a contributing factor in attempts to mislead investors about a company's financial condition. Therefore, providing the audit committee with information regarding significant unusual transactions could benefit the audit committee in its oversight of the financial reporting process.

Some commenters suggested that the standard include a definition of the term "significant unusual transactions." Auditing Standard No. 16 describes significant unusual transactions as 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, which is consistent with the description of this term in other PCAOB standards, such as Auditing Standard No. 12.[39] Therefore, the standard was not revised to further define significant unusual transactions.

D. Consideration of Communications Made by Management (Note to Paragraph 12 of Auditing Standard No. 16)

Auditing Standard No. 16 retains the substance of the communication requirements in AU sec. 380 regarding accounting policies, practices, and estimates. The requirement in the standard for the auditor to communicate critical accounting policies and practices is consistent with Section 10A(k) of the Exchange Act, which requires auditors of issuers to report all critical accounting policies and practices to the issuer's audit committee.[40] In addition, Auditing Standard No. 16 includes a new requirement related to the communication of significant unusual transactions.

Many commenters suggested that the standard should recognize that management has the primary responsibility for reporting to the audit committee and that the auditor's responsibility should be to confirm that management has appropriately communicated. No change was made in response to this comment because, similar to AU sec. 380, Auditing Standard No. 16 acknowledges that management also may be communicating certain matters related to the financial reporting process to the audit committee. The Board recognizes that management as well as the auditor might discuss accounting policies, practices, estimates, and significant unusual transactions with the audit committee and that it would not be cost-effective or practical for the audit committee to listen to essentially the same presentation twice. Therefore, Auditing Standard No. 16 indicates that, in situations in which management communicates matters in paragraph 12, the auditor's communication requirement under the standard would be met if the auditor: (1) participates in management's discussion with the audit committee,[41] (2) affirmatively confirms to the audit committee that

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[39] Paragraph 71.g. of Auditing Standard No. 12.

[40] *See also* SEC Rule 2-07.

[41] The auditor's participation in management's discussion with the audit committee could be satisfied in person or via audio or video conference.

management has adequately communicated these matters, and (3) with respect to critical accounting policies and practices, identifies for the audit committee those accounting policies and practices that the auditor considers critical. In addition, the auditor should communicate any omitted or inadequately described matters to the audit committee.

In situations in which management makes those communications to the audit committee, in order to satisfy the communication requirement in Auditing Standard No. 16, the auditor would be required to participate during discussions between management and the audit committee regarding accounting policies, practices, estimates, and significant unusual transactions, which may include discussions of the importance of critical accounting policies, practices or estimates, or the difficult, subjective, or complex nature of the judgment involved in significant unusual transactions, or the selection or application of accounting policies, practices, or estimates. If the auditor to identifies the accounting policies and practices that the auditor considers critical to the portrayal of the company's financial condition and results and affirmatively confirms that management has adequately communicated the accounting policies, practices, estimates, and significant unusual transactions to the audit committee in a meeting in which the auditor participated the auditor would be deemed to satisfy the requirement for the auditor to report all critical accounting policies and practices to the audit committee, without the need for the auditor to repeat management's presentation on the same topic.

Conversely, if the auditor (1) did not participate in management's meeting with the audit committee in which communication regarding accounting policies, practices, estimates, and significant unusual transactions occurred, (2) did not affirmatively confirm that accounting policies, practices, estimates, and significant unusual transactions had been discussed adequately by management, or (3) with respect to critical accounting policies and practices, did not identify those accounting policies and practices that the auditor considers critical, then the auditor would be required to communicate to the audit committee the matters described in paragraph 12 of Auditing Standard No. 16, regardless of any management communication regarding those matters.

VIII. Auditor's Evaluation of the Quality of the Company's Financial Reporting (Paragraph 13 of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to communicate certain matters to the audit committee regarding the auditor's views of the audit and the financial statements as described below.

A. Qualitative Aspects of Significant Accounting Policies and Practices (Paragraph 13.a. of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to communicate the results of the auditor's evaluation of, and conclusions about, the qualitative aspects of the company's significant accounting policies and practices, including situations in which the auditor identified bias in management's judgments about the amounts and disclosures in the financial statements. This requirement is similar to certain communication requirements that have been superseded. AU sec. 380 required the auditor to discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's

accounting principles.[42] Additionally, AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312*, required the auditor to consider whether matters related to management bias should be communicated to the audit committee.[43]

The requirement in Auditing Standard No. 16 is designed for the auditor to communicate the results of the auditor's procedures under Auditing Standard No. 14, *Evaluating Audit Results*, which requires the auditor to, among other things, evaluate the qualitative aspects of the company's accounting practices,[44] including potential bias in management's judgments about the amounts and disclosures in the financial statements.[45]

Additionally, Auditing Standard No. 16 requires the auditor to communicate to the audit committee the results of the auditor's evaluation of the differences between (i) estimates best supported by audit evidence and (ii) estimates included in the financial statements, which are individually reasonable, that indicate a possible bias on the part of the company's management. This communication is designed for the auditor to discuss the results of the auditor's evaluation of these matters as required under Auditing Standard No. 14.[46] Linking the communication requirements with performance requirements in Auditing Standard No. 14 provides context regarding the matters to be communicated.

Some commenters suggested that the standard should retain the requirement in AU sec. 380 for the auditor to discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles. Auditing Standard No. 16 modifies the requirement from AU sec. 380 by requiring the auditor to communicate to the audit committee the results of the auditor's evaluation of, and conclusions about, the qualitative aspects of the company's significant accounting policies and practices, while linking the communication requirement to the performance requirement in Auditing Standard No. 14. Therefore, no change was made in response to these comments.

B. Assessment of Critical Accounting Policies and Practices (Paragraph 13.b. of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to communicate to the audit committee the auditor's assessment of management's disclosures related to the critical accounting policies and practices, along with any significant modifications to the disclosures of those policies and practices proposed by the auditor that management did not make. This requirement is based on the Exchange Act's requirement that the auditor report to the audit committee all critical accounting policies and practices.[47] In the release adopting the SEC's related rule, the SEC indicated that it anticipated that the auditor's communications to the audit committee regarding critical accounting policies would include an assessment of management's disclosures along with any significant proposed modifications by the auditor that were not included in those disclosures.[48]

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[42] AU sec. 380.11.

[43] Following the original proposal of this standard, AU sec. 9312 was superseded when the Board adopted the risk assessment standards. The performance requirement of AU sec. 9312, however, was substantially included in the risk assessment standards.

[44] *See* paragraphs 24-27 of Auditing Standard No. 14.

[45] *Id*.

[46] *See* paragraph 27 of Auditing Standard No. 14.

[47] *See* Section 10A(k) of the Exchange Act, 15 U.S.C. §78j-1(k); and SEC Rule 2-07.

[48] *See* Securities Act Release No. 8183.

C. Conclusions Regarding Critical Accounting Estimates (Paragraph 13.c. of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to communicate the basis for the auditor's conclusions regarding the reasonableness of the critical accounting estimates. This requirement is similar to a requirement in AU sec. 380.[49] This requirement is designed to require the auditor to communicate the results of the auditor's procedures regarding critical accounting estimates under PCAOB standards, such as AU sec. 342.[50] Communicating these results will provide the audit committee with the auditor's assessment of the critical accounting estimates based on the auditor's procedures.

D. Significant Unusual Transactions (Paragraph 13.d. of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to communicate to the audit committee the auditor's understanding of the business rationale for significant unusual transactions. This communication requirement is aligned with the performance requirement in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* which requires the auditor to gain an understanding of the business rationale regarding significant transactions that are outside the normal course of business or that otherwise appear unusual.[51] This communication would provide the audit committee with an opportunity to receive the auditor's perspective of such transactions.

In a separate rulemaking project, the Board has proposed amendments to AU sec. 316 that would require the auditor to design and perform procedures to obtain an understanding of the business purpose (or lack thereof) of each significant unusual transaction and evaluate whether the business purpose (or the lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.[52] If, at the conclusion of that rulemaking project, the Board adopts the proposed amendments to AU sec. 316, the Board will consider, as appropriate, amending Auditing Standard No. 16 to align the communication with any new performance requirements.

E. Financial Statement Presentation (Paragraph 13.e. of Auditing of Auditing Standard No. 16)

Similar to AU sec. 380.11, Auditing Standard No. 16 requires the auditor to communicate to the audit committee the results of the auditor's evaluation of whether the presentation of the financial statements and the related disclosures are in conformity with the applicable financial reporting framework, including the auditor's 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, and the bases of amounts set forth. This communication requirement

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[49] *See* AU sec. 380.08.

[50] *See* AU secs. 342.04, 09-.10.

[51] *See* AU sec. 316.66.

[52] *Proposed Auditing Standard - Related Parties*, *Proposed Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions*, *and Other Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2012-001 (Feb. 28, 2012).

relates to the auditor's evaluation of whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, as required by Auditing Standard No. 14.[53]

Some commenters suggested that the standard should retain the requirement in AU sec. 380 for the auditor to discuss with the audit committee the auditor's views about the clarity and completeness of the company's financial statements and disclosures. However, commenters on the original proposed standard indicated it was not clear what was meant by the clarity and completeness of the company's financial statements and related disclosures. Commenters also expressed concern as to what should be included in the communications to the audit committee. The communication requirement in Auditing Standard No. 16 avoids possible confusion regarding the meaning of the phrase "clarity and completeness" by linking it to the auditor performance requirements included in Auditing Standard No. 14 for the auditor to evaluate the presentation of the financial statements, including disclosures. The performance requirements in Auditing Standard No. 14[54] provide context regarding the matters to be communicated under Auditing Standard No. 16.

F. New Accounting Pronouncements (Paragraph 13.f. of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to communicate to the audit committee situations in which, as a result of the auditor's procedures, the auditor identified a concern regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting. This requirement is based on the situations in which, as a result of the auditor's procedures, the auditor has identified a concern regarding the anticipated application of a new accounting pronouncement. Auditing Standard No. 16 does not require the auditor to perform additional procedures to identify such concerns.

Some commenters noted that management generally discloses in the financial statements the potential effects of adoption of new accounting standards and that this auditor communication to the audit committee should be related to the auditor's evaluation of management's disclosures related to new accounting pronouncements. The intent of the required communication to the audit committee is not meant to provide an additional evaluation of management's disclosures. Rather, the intent is to inform the audit committee when the auditor "has identified a concern" regarding the planned implementation of a new accounting pronouncement or whether management has devoted adequate resources to prepare its accounting and disclosure processes, and other financial reporting systems, for the timely implementation of the new accounting pronouncement. This communication might inform the audit committee's oversight of the company's financial reporting process. Requiring the discussion of such matters is intended to allow the audit committee to properly consider the auditor's concerns regarding future financial statements. Accordingly, no change to the standard was made.

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[53] See paragraphs 30-31 of Auditing Standard No. 14, which describe the auditor's responsibility relating to the evaluation of whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

[54] *Id.*

G. Alternative Accounting Treatments (Paragraph 13.g. of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to communicate all alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the auditor. This requirement is consistent with Section 10A(k) of the Exchange Act and with SEC Rule 2-07, which requires the auditor to report to the audit committee all alternative treatments that are related to material items, were discussed with management, and are permissible under the applicable financial reporting framework.[55]

IX. Other Information in Documents Containing Audited Financial Statements (Paragraph 14 of Auditing Standard No. 16)

Auditing Standard No. 16 retains the requirement from AU sec. 380.12 for the auditor to communicate to the audit committee the auditor's responsibility under PCAOB rules and standards for other information presented in documents containing audited financial statements, any related procedures performed, and the results of such procedures. Such other information would include documents described in AU sec. 550, AU sec. 558, *Required Supplementary Information,* and AU sec. 711, *Filings Under Federal Securities Statutes*.

The auditor's responsibility under AU sec. 550 requires the auditor to read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, in the financial statements.[56] One commenter suggested that Auditing Standard No. 16 should also include a requirement to communicate any identified material inconsistencies or misstatements of facts, including the auditor's response to such matters.

Auditing Standard No. 16 requires the auditor to communicate the results of the auditor's procedures related to other information in documents containing audited financial statements, which would require the auditor to communicate identified inconsistencies or misstatements of facts to the audit committee. The Board is amending AU sec. 550 to require the auditor to communicate to the audit committee the material inconsistency between the other information and the financial statements in situations in which the information is not revised to eliminate the material inconsistency. The Board also is amending AU sec. 550 to require the auditor to communicate to the client and the audit committee, in writing, a material misstatement of fact in the other information. Thus, it was not necessary to revise the standard in response to commenters. Appendix 3 of the release provides the amendments to PCAOB standards as a result of the adoption of Auditing Standard No. 16.

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[55] *See* SEC Rule 2-07, Section 10A(k) of the Exchange Act, 15 U.S.C. §78j-1(k), and Securities Act Release No. 8183.

[56] *See generally*, AU secs. 550.04-.07, which require that the auditor read the information and consider whether it is materially inconsistent with information in the financial statements or whether it contains any material misstatements of fact.

X. Difficult or Contentious Matters for which the Auditor Consulted (Paragraph 15 of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to communicate to the audit committee matters that are difficult or contentious for which the auditor consulted outside the engagement team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process. The required communications of difficult or contentious matters are based on the results of the procedures the auditor performed regarding such matters during the course of the audit and do not require the performance of new or additional procedures.

Many matters that arise during an audit can be complex or unusual, and the auditor might consult on such matters with the firm's national office, industry specialists, or external parties. Difficult or contentious issues can arise in various stages of the audit, including in the auditor's evaluation of management's judgments, estimates, accounting policies, or assessment of identified control deficiencies. Difficult or contentious issues generally are the critical matters that concern the auditor when he or she is making the final assessment of whether the financial statements are presented fairly.

A difficult issue might not always be synonymous with a contentious issue. Rather, a difficult issue might be a matter that requires consultation. A contentious issue might be a matter that not only requires consultation but also leads to significant points of disagreement, debate, or deliberation between the auditor and management. Audit committees might better appreciate the importance of difficult or contentious matters if they are aware that such consultations took place.

During the course of the audit difficult or contentious issues might arise for which the auditor did not consult, but which the auditor believes are relevant to the audit committee's oversight of the financial reporting process. Auditing Standard No. 16 does not preclude the auditor from communicating to the audit committee difficult or contentious matters for which the auditor did not consult outside the engagement team.

Some commenters suggested that the standard should define difficult or contentious matters. The term "difficult or contentious matter" is used in Auditing Standard No. 7, *Engagement Quality Review.* Therefore, the term "difficult or contentious matter" is not defined in this standard.

Some commenters suggested that the standard should exclude the discussions between the auditor and the engagement quality reviewer from communications to the audit committee regarding consultation outside the engagement team on difficult or contentious matters. The communication to the audit committee in Auditing Standard No. 16 focuses on the difficult or contentious matters on which the auditor consulted, not on the parties involved in the consultation. Therefore, the standard was not revised.

XI. Management Consultation with Other Accountants (Paragraph 16 of Auditing Standard No. 16)

When the auditor is aware that management consulted with other accountants about significant auditing or accounting matters and the auditor has identified a concern regarding such matters, Auditing Standard No. 16 requires the auditor to communicate to the audit committee the auditor's views about such

matters that were the subject of such consultation. This requirement is similar to a requirement in AU sec. 380.[57] Communicating matters that were the subject of consultations only when the auditor has identified a concern about those matters should allow the audit committee to focus its efforts on important accounting and auditing issues.

Some commenters suggested that communicating management consultations with other accountants should be management's responsibility and that the standard should clarify that the auditor should comment only on what management has communicated regarding such consultations. The standard does not impose a communication requirement on management. The requirement in Auditing Standard No. 16 is specifically related to the auditor's responsibilities when management has consulted with other accountants and only when the auditor has a concern regarding the accounting and auditing matters that were the subject of management's consultations. Therefore, Auditing Standard No. 16 was not revised.

As part of the comment process, the Board asked whether the requirement to communicate about consultations should be expanded to include consultations on accounting or auditing matters with non-accountants, such as consulting firms or law firms. Some commenters suggested that communication regarding management's consultations with non-accountants should be required, while others suggested that communication about these consultations should be made at the auditor's discretion depending on the facts or circumstances and the significance of the consultation to the financial statements. However, many commenters indicated that this communication should not be expanded to include consultations with non-accountants, as the auditors would not be in position to know about all management consultations with non-accountants. Some commenters indicated that this requirement could result in the auditor expending significant effort to identify and evaluate management's consultations with non-accountants. After consideration of these comments, the standard was not revised to require the auditor to communicate management's consultation with non-accountants.

XII. Going Concern (Paragraph 17 of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to communicate to the audit committee certain matters related to the auditor's evaluation of the company's ability to continue as a going concern. The communication requirements in Auditing Standard No. 16 are based on the auditor's performance requirements under AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, which requires the auditor to evaluate whether there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.[58] The auditor's communication to the audit committee regarding the auditor's evaluation of the company's ability to continue as a going concern can serve to further inform the audit committee, in certain circumstances, regarding difficult conditions and events that the company is encountering.

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[57] AU sec. 380.14.

[58] *See* AU sec. 341.06, which provides examples of such conditions and events and AU sec. 341.07, which discusses the auditor's procedures if the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.

Auditing Standard No. 16 requires the auditor to communicate the conditions and events the auditor identified that, when considered in the aggregate, lead the auditor to believe that there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time. Information about such conditions and events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions in the financial statements.[59] Examples of such conditions and events include, but are not limited to, negative trends, other indications of possible financial difficulties, internal matters, or external matters that have occurred.[60]

Under AU sec. 341, if after considering the identified conditions and events, in the aggregate, the auditor believes that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, the auditor should consider management's plans for dealing with the adverse effects of the conditions and events.[61] Additionally, the auditor should obtain information about the plans and consider whether it is likely that the adverse effects will be mitigated for a reasonable period of time, and that such plans can be effectively implemented.[62] Auditing Standard No. 16 requires that if the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern is alleviated, the auditor should communicate to the audit committee the basis for the auditor's conclusion, including elements the auditor identified within management's plans that are significant to overcoming the adverse effects of the conditions and events.[63]

Under AU sec. 341, if the auditor concludes that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph to reflect the auditor's conclusion that there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.[64] Additionally, Auditing Standard No. 16 requires that if the auditor concludes that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time remains,[65] the auditor should communicate to the audit committee: (1) the effects, if any, on the financial statements and the adequacy of the related disclosure;[66] and (2) the effects on the auditor's report.[67]

The reproposed standard required the auditor to communicate the conditions and events the auditor identified that, when considered in the aggregate, indicate that there "could be" substantial doubt about the company's ability to continue as a going concern for a reasonable period of time. Some commenters

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[59] *See* AU sec. 341.02.

[60] *See* AU sec. 341.06, which provides examples of such conditions and events.

[61] *See* AU sec. 341.07, which discusses the auditor's procedures if the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.

[62] *See* AU sec. 341.03b.

[63] *See* AU sec. 341.08, which discusses the auditor's responsibilities related to the auditor's evaluation of management's plans.

[64] *See* AU sec. 341.12.

[65] *See* AU sec. 341.03c, which discusses the auditor's evaluation of factors that indicate there is substantial doubt about the company's ability to continue as a going concern.

[66] *See* AU sec. 341.10, which discusses the possible effects on the financial statements and the adequacy of the related disclosure.

[67] *See* AU secs. 341.12-.16, which discuss the auditor's consideration of the effects on the auditor's report when the auditor concludes that substantial doubt exists about the company's ability to continue as a going concern for a reasonable period of time.

suggested that the threshold for communication to the audit committee should be when the auditor believes there "is" substantial doubt about the company's ability to continue as a going concern, rather than when there "could be" substantial doubt. Those commenters suggested that threshold because, under AU sec. 341, the auditor is required to consider management's plans for addressing the adverse effects of the events and conditions when the auditor believes there "is" substantial doubt.

Auditing Standard No. 16 was revised to require the threshold for the auditor's initial communication to the audit committee to be when the auditor "believes there is" substantial doubt about the company's ability to continue as a going concern. This aligns more closely the communication requirement about the conditions and events with the other communication requirements in paragraph 17 of Auditing Standard No. 16. Under paragraph 17 of Auditing Standard No. 16 the auditor is required to communicate conditions and events, along with the auditor's conclusion regarding whether either management's plans alleviate the adverse effects of the conditions and events (item b) or substantial doubt remains (item c).

XIII. Uncorrected and Corrected Misstatements (Paragraphs 18-19 of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to provide the audit committee with the schedule of uncorrected misstatements[68] relating to accounts and disclosures that was presented to management. Several commenters indicated that audit committees would not find value in information presented at the same level of detail as presented to management, and that the auditor, therefore, should provide a summary of misstatements to the audit committee.

The Board decided to retain the requirement because presenting a schedule that shows only a summary of the uncorrected misstatements rather than the individual misstatements might not be informative for the audit committee. In addition, the requirement in Auditing Standard No. 16 is not a significant change from AU sec. 380.10, which required the presentation to the audit committee of a schedule of uncorrected misstatements.

The schedule of uncorrected misstatements required by Auditing Standard No. 16 is similar to the summary of uncorrected misstatements included in or attached to the management representation letter.[69] Additionally, the Exchange Act and SEC Rule 2-07 require the auditor to provide to the audit committee other material written communications between the auditor and management, which would include the schedule of unadjusted audit differences and a listing of adjustments and reclassifications not recorded, if any.[70]

Auditing Standard No. 14 requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial, and to communicate those to management on a timely basis.[71] According to Auditing Standard No. 14, a misstatement may relate to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item

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[68] Footnote 13 to paragraph 20 of Auditing Standard No. 14 indicates that misstatements include both omissions and the presentation of inaccurate or incomplete disclosures.

[69] *See* paragraph .06g of AU sec. 333, *Management Representation*.

[70] *See* Section 10A(k)(3) of the Exchange Act, 15 U.S.C. §78j-1(k)(3), SEC Rule 2-07(a)(3) and Securities Act Release No. 8183.

[71] *See* paragraphs 10 and 15 of Auditing Standard No. 14.

and the amount, classification, presentation, or disclosure that should be reported in conformity with the applicable financial reporting framework.[72] The requirement in Auditing Standard No. 16 to communicate misstatements related to accounts and disclosures relates only to those misstatements that the auditor has accumulated throughout the audit that are not clearly trivial and have been reported to management.

Auditing Standard No. 16 also requires the auditor to discuss with the audit committee, or determine that management has adequately discussed with the audit committee, the basis for the determination that the uncorrected misstatements were immaterial, including the qualitative factors[73] considered. In addition, the auditor also should communicate to the audit committee that uncorrected misstatements or matters underlying those uncorrected misstatements could potentially cause future-period financial statements to be materially misstated, even if the auditor has concluded that the uncorrected misstatements are immaterial to the financial statements under audit.

Auditing Standard No. 16 also requires the auditor to communicate those corrected misstatements, other than those that are clearly trivial, related to accounts and disclosures that might not have been detected except through the auditing procedures performed and discuss with the audit committee the implications that such corrected misstatements might have on the financial reporting process.

One commenter suggested that the standard should require the auditor to communicate management's adjusting entries recorded at the end of the period or other entries to reconcile accounts. The release accompanying the original proposed standard included a question that asked whether all corrected misstatements, including those detected by management, should be communicated to the audit committee. Many commenters responding to the question were not supportive of the auditor communicating misstatements detected by management or management's period-end adjusting entries, because the auditor may not have knowledge of all such adjustments due to the nature of a company's financial statement close process and the timing of the auditor's procedures. Commenters suggested that such a requirement would likely result in the auditor expending significant effort to identify misstatements or adjusting entries that the company's internal controls previously identified in the financial close process. Accordingly, the standard does not include a requirement for the auditor to communicate misstatements detected by management.

Some commenters suggested that the standard should be revised to require the auditor to communicate only corrected misstatements that individually or in the aggregate could be significant to the company's financial statements. As noted previously, Auditing Standard No. 14 requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial. The misstatements the auditor accumulated and management corrected are those that are other than clearly trivial and could be significant to the company's financial statements, either quantitatively or qualitatively. Auditing Standard No. 16 also requires the auditor to communicate those corrected misstatements that might not have been detected except through the auditing procedures performed. The intent of this requirement is to inform the audit committee of misstatements, which might have certain implications

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[72] *See* paragraph A2 of Auditing Standard No. 14.

[73] *See* Appendix B of Auditing Standard No. 14, which discusses the qualitative factors related to the evaluation of the materiality of uncorrected misstatements.

on the company's financial reporting process, that were detected only through audit procedures. Therefore, Auditing Standard No. 16 was not revised.

Another commenter suggested that the standard should specifically require the auditor to request management to correct the uncorrected misstatements. The Board did not make this change 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 Exchange Act requires the financial statements filed with the SEC to reflect all material correcting adjustments identified by the auditor.[74]

XIV. Material Written Communication (Paragraph 20 of Auditing Standard No. 16)

Auditing Standard No. 16 incorporates the Exchange Act's requirement for the auditor to communicate other material written communications between the auditor and management to the audit committee.[75] This requirement is intended to capture other possible material written communications that might occur but are not addressed by requirements in the standard or by other PCAOB standards, such as the management representation letter.[76]

XV. Departure from the Auditor's Standard Report (Paragraph 21 of Auditing Standard No. 16)

Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee when the auditor expects to modify the opinion in the auditor's report or include explanatory language or an explanatory paragraph in the auditor's report.[77] The auditor is required to communicate the reasons for and the wording of the modification, explanatory language, or explanatory paragraph. The requirement is intended to provide the basis for a discussion between the auditor and the audit committee in those circumstances in which the auditor expects to add explanatory language or modify the opinion in the auditor's standard report.

As part of overseeing the audit and the financial reporting process, it might be important for the audit committee to understand the reasons an auditor adds explanatory language or modifies the opinion in the auditor's standard report. Such communication enables the audit committee to be aware of the nature of any specific matters that the auditor expects to highlight in the auditor's report. In addition, these communications provide the audit committee with an opportunity to obtain further clarification from the auditor about the modification. This communication also provides the audit committee with an opportunity to provide the auditor with further information and explanations regarding the matters that are expected to be included in the auditor's report.

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[74] Section 13(i) of the Exchange Act, 15 U.S.C. § 78j-1(m)(i).

[75] Section 10A(k)(3) of the Exchange Act, 15 U.S.C. § 78j-1(k)(3), requires the auditor to report this information to the audit committee; *see also* SEC Rule 2-07.

[76] *See* Securities Act Release No. 8183 for a discussion of the substance of other material written communications.

[77] *See* paragraphs .11-.74 and .76 of AU sec. 508, *Reports on Audited Financial Statements*.

XVI. Disagreements with Management (Paragraph 22 of Auditing Standard No. 16)

Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee any disagreements with management about matters, whether or not satisfactorily resolved, that individually or in the aggregate could be significant to the company's financial statements or the auditor's report. This requirement is retained from AU sec. 380.13.

Examples of disagreements might include disagreements with management about the application of accounting principles to the company's specific transactions and events and the basis for management's judgments about accounting estimates. Disagreements might also arise regarding the scope of the audit, disclosures to be made in the company's financial statements, or the wording of the auditor's report. For purposes of Auditing Standard No. 16, disagreements do not include differences of opinion based on incomplete facts or preliminary information that are later resolved by the auditor obtaining additional, relevant facts or information prior to the issuance of the auditor's report.

One commenter suggested that disagreements that are satisfactorily resolved should not be communicated to the audit committee unless the auditor determines that these matters warrant the audit committee's attention. As noted previously, this communication requirement is not new. As part of conducting the oversight of the audit and the financial reporting process, it might be important for the audit committee to know the areas of tension between the auditor and management regarding matters that could be significant to the company's financial statements, such as accounting principles and practices, financial statement disclosures, auditing scope or procedures, or similar matters. Accordingly, no change was made in response to this comment. Additionally, SEC Form 8-K requires that a registrant report certain disagreements between management and the auditor, whether or not such disagreements are satisfactorily resolved, when there is a change in the auditor.[78] The requirement in Auditing Standard No. 16 provides the audit committee with information regarding important matters that might need to be reported subsequently in an SEC filing.

XVII. Difficulties Encountered in Performing the Audit (Paragraph 23 of Auditing Standard No. 16)

Auditing Standard No. 16 includes the requirement from AU sec. 380.16 for the auditor to communicate to the audit committee any significant difficulties encountered during the audit. Significant difficulties encountered during the audit include, but are not limited to:

- Significant delays by management, the unavailability of company personnel, or an unwillingness by management to provide information needed for the auditor to perform his or her audit procedures;
- An unreasonably brief time within which to complete the audit;

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[78] *See e.g.,* Exchange Act Form 8-K, Item 4.01. *See also* Item 304(a)(1)(iv) of Regulation S-K, 17 C.F.R. §229.304(a)(1)(iv), and Instructions 4 and 5 to that item, which require disclosure of disagreements, or differences of opinion, at the "decision-making level," that, if not resolved to the auditor's satisfaction, would have caused the auditor to make reference to the subject matter of the disagreement in connection with his or her report.

- Unexpected extensive effort required by the auditor to obtain sufficient appropriate audit evidence;
- Unreasonable management restrictions encountered by the auditor on the conduct of the audit; and
- Management's unwillingness to make or extend its assessment of the company's ability to continue as a going concern when requested by the auditor.

XVIII. Other Matters (Paragraph 24 of Auditing Standard No. 16)

Auditing Standard No. 16 requires the auditor to communicate to the audit committee other matters arising from the audit that are significant to the oversight of the company's financial reporting process. This communication includes, among other matters, complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit and the results of the auditor's procedures regarding such matters. Communication of the other matters is based on the results of audit procedures or the conduct of the audit and does not require the auditor to perform new or additional procedures beyond the communication itself.

The Act requires that audit committees of listed companies establish procedures for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting control, or auditing matters, and for the confidential, anonymous submission by employees of the company of concerns regarding questionable accounting or auditing matters.[79]

Auditing Standard No. 12 requires the auditor to inquire of the audit committee regarding tips or complaints received by the audit committee regarding financial reporting matters. The auditor might become aware of complaints or concerns regarding financial reporting matters that were not received through the audit committee's process, and, therefore, are unknown to the audit committee. The audit committee might be better able to exercise its oversight activities if the auditor informed the audit committee of these matters. Paragraph 24 of Auditing Standard No. 16 requires the auditor to communicate these matters to the audit committee.

AU sec. 380 required the auditor to ensure that the audit committee receives additional information regarding the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and disclosure process. Auditing Standard No. 16 enhances the requirement in AU sec. 380 for the auditor to communicate to the audit committee the results of the audit procedures regarding the accounting or auditing matters that have been the subject of complaints or concerns.

The standard acknowledges that there might be other matters known to the auditor that may be beneficial to the audit committee's oversight of the financial reporting process. This communication could provide the audit committee with an opportunity to better understand management's intentions regarding such matters.

Several commenters suggested that Auditing Standard No. 16 should require the auditor to communicate to the audit committee the results of PCAOB inspection findings and any necessary remediation by the audit firm. With respect

[79] *See* Section 301 of the Act, and Section 10A(m)(4) of the Exchange Act, 15 U.S.C. §78j-1(m)(4).

to inspections, the Act restricts what the Board may publicly disclose,[80] and the Act makes no exception for disclosure to an audit committee even if a Board inspection has reviewed an audit of the financial statements overseen by that audit committee. The Board cannot compel a firm to disclose nonpublic inspection information to an audit committee. This need not prevent an audit committee from discussing inspection results with its auditor. The Board encourages firms to communicate effectively with audit committees about inspection matters. The Act does not restrict a firm from disclosing to an audit committee nonpublic information regarding PCAOB inspections (including quality control deficiencies and the firm's remediation of those deficiencies) or PCAOB disciplinary matters.[81]

XIX. Form and Documentation of Communications (Paragraph 25 of Auditing Standard No. 16)

Auditing Standard No. 16 retains from AU sec. 380 the ability for auditors to communicate to the audit committee either orally or in writing, unless otherwise specified in the standard. Some commenters suggested that the standard should require all communications to be in writing, while other commenters indicated that the standard should continue to provide flexibility in the manner of communication.

Auditing Standard No. 16 was not revised to require all communications to be in writing. The Board's intention is to promote effective two-way communication between the auditor and the audit committee, whether through presentations, written reports, or interactive discussions. Written communications might provide the auditor with a basis to lead an active two-way discussion with the audit committee.

In addition, the form of communication may depend on the nature of the matter to be communicated. For example, written information often makes it easier for the audit committee to understand highly complex information (for example, information about critical accounting estimates). However, having a dialogue on key matters often is an important factor in effective communications between the auditor and the audit committee.

Auditing Standard No. 16 also requires the auditor to document the communications in the work papers, whether such communication took place orally or in writing. The standard further requires the auditor to include a copy of or a summary of management's communications provided to the audit committee in the audit documentation if, as part of its communications to the audit committee, management communicated some or all of the matters identified in paragraphs 12 or 18 and, as a result, the auditor did not communicate these matters at the same level of detail as management.

XX. Timing (Paragraph 26 of Auditing Standard No. 16)

The Board considers communications with audit committees to be an integral part of the audit process. AU sec. 380 stated that audit committee communications are incidental to the audit and are not required to occur before the

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[80] *See* Section 104(g)(2) of the Act (providing that the Board shall make inspection reports available to the public in appropriate detail "subject to," among other things, the broad disclosure restrictions of Section 105(b)(5)(A)).

[81] *See Information for Audit Committees About the PCAOB Inspection Process*, PCAOB Release No. 2012-003 (Aug. 1, 2012).

issuance of the auditor's report on the entity's financial statements so long as the communications occur on a timely basis.[82] Auditing Standard No. 16 requires the auditor to communicate the matters required by the standard in a timely manner and prior to the issuance of the auditor's report. This requirement aligns the timing of communications with SEC Rule 2-07, which requires the auditor to communicate matters to the audit committee prior to the filing of the auditor's report with the SEC.[83] The appropriate timing of a particular communication to the audit committee depends on factors such as the significance of the matters to be communicated and corrective or follow-up actions needed, unless other timing requirements are specified by PCAOB rules or standards or the securities laws.

The reproposed standard specified that all communications be made in a timely manner and prior to the issuance of the auditor's report, unless other timing requirements are specified by PCAOB rules or standards or the rules or regulations of the SEC. One commenter suggested that the "rules and regulations of the SEC" should be modified to the "federal securities laws," since timing of certain communications to the audit committee also is specified in securities laws. The standard was updated to reference "securities laws."[84]

Commenters generally agreed that audit committee communications should occur in a timely manner and prior to the issuance of the auditor's report. Some commenters suggested that the standard should specify the timing of the communication about certain matters, such as during planning or prior to the earnings release.

Auditing Standard No. 16 does not emphasize the specific timing of certain communications because the appropriate timing might vary depending on the circumstances. As noted in the standard, the appropriate timing of a particular communication to the audit committee depends on factors such as the significance of the matters to be communicated and any corrective or follow-up action needed, unless other timing requirements are specified by PCAOB rules or standards or the securities laws. However, in all events, the timing of the communication should be prior to the issuance of the auditor's report.

Providing communications required by Auditing Standard No. 16 to the audit committee in a timely manner and prior to the issuance of the auditor's report will allow the audit committee and the auditor the opportunity to take any action they may deem appropriate to address the matters communicated prior to the issuance of the auditor's report.

The reproposed standard noted that an auditor may communicate to only the audit committee chair if done in order to communicate matters in a timely manner during the audit; however, the auditor should communicate such matters to the full audit committee prior to the issuance of the auditor's report. Several commenters suggested that the auditor's responsibility to subsequently communicate to the "full" audit committee was an unnecessary burden and that the word "full" should be deleted to allow the auditor to communicate to the audit committee when a quorum is present. The standard was revised accordingly to eliminate the word "full."

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[82] AU sec. 380.04.

[83] *See* SEC Rule 2-07.

[84] The term "securities laws" is defined in section 2(a)(15) of the Act, 15 U.S.C. § 7201, to mean the provisions of law referred to section 3(a)(47) of the Exchange Act, 15 U.S.C. § 78c(a)(47), as amended by the Act, and includes the rules, regulations, and orders issued by the SEC thereunder.

XXI. Adequacy of the Two-Way Communication Process

The original proposed standard included a requirement for the auditor to evaluate whether the two-way communication between the auditor and the audit committee was adequate to support the objectives of the audit. The requirement was included to emphasize that effective two-way communication is beneficial to achieving the objectives of the audit.

Many commenters on the original proposed standard noted that an evaluation of the adequacy of the two-way communications can only be effective if both parties are involved in the evaluation. These commenters also suggested that if only the auditor evaluates the effectiveness based on his or her understanding of what was communicated, that evaluation would not provide information about the audit committee's understanding of that communication. In response to commenters, the Board removed this requirement in the reproposed standard.

Some commenters on the reproposed standard indicated that the Board should reinstate the requirement for the auditor to evaluate the adequacy of the two-way communication between the auditor and the audit committee to encourage the auditor to determine whether there is effective two-way communication. Additionally, some commenters suggested that the standard should be revised to change certain requirements for the auditor to communicate "with" the audit committee instead of "to" the audit committee in situations in which two-way discussion would be appropriate for the auditor to obtain information on particular matters relevant to the audit.

The note in paragraph 3 of Auditing Standard No. 16 states that the requirement for the auditor to "communicate to" the audit committee is meant to encourage effective two-way communication between the auditor and the audit committee throughout the audit to assist in understanding matters relevant to the audit. The importance of effective two-way communications remains in the standard; therefore, no change was considered necessary.

In addition, as part of understanding the company's control environment in Auditing Standard No. 12, the auditor assesses whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.[85] Other PCAOB standards require that, in an audit of financial statements, if the auditor becomes aware, or in an integrated audit, if the auditor concludes that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that information in writing to the board of directors.[86] Not including a requirement for the auditor to evaluate the adequacy of a two-way communication in this standard does not change the auditor's responsibility for assessing the audit committee's effectiveness under existing PCAOB standards.

XXII. Audits of Brokers and Dealers

The release accompanying the reproposed standard posed a question about whether the standard should apply to the audits of all brokers and dealers. Many commenters supported the requirement for the standard to apply to the audits of all brokers and dealers. However, some commenters suggested that it may not be practicable to communicate the matters in the standard because they may not be applicable to all brokers and dealers due to the varying size and

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[85] *See* paragraphs 23-24 of Auditing Standard No. 12.

[86] *See* paragraph 79 of Auditing Standard No. 5 and paragraph 5 of AU sec. 325.

nature of the brokers and dealers as well as the difference in their governance structures. Some commenters suggested that these brokers and dealers may not have an audit committee, board of directors, or equivalent body, or that the individual designated to oversee the financial reporting process and audits of the company might be the same person preparing the financial statements. They suggested, therefore, that the standard should apply only to certain types of brokers and dealers, such as carrying brokers or dealers. Other commenters suggested that the standard should not be applicable to the audits of brokers and dealers.

The Board acknowledges that there are smaller, less complex brokers and dealers that do not have an audit committee, board of directors, or equivalent body, but that communicating matters about the audit and the financial statements to those overseeing the financial reporting process is important. The governance structure of brokers and dealers does not change the value of the information regarding the audit or the company's financial statements.

Therefore, as discussed in Section I of this appendix, the definition of audit committee was revised for audits of nonissuers to recognize that if no such committee or board of directors (or equivalent body) exists with respect to the company, the communication should be made to the person(s) who oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.

The release accompanying the reproposed standard posed a question about whether there are any communication requirements specific to the audits of all brokers and dealers that should be added to the standard. Some commenters suggested that the standard should require additional communication to the audit committee related to the additional attestation reporting to be required for brokers and dealers as proposed in pending SEC amendments to its Rule 17a-5.[87] Once the amendments to Rule 17a-5 are adopted in final form, the Board may consider adding requirements for communication to the audit committee pertaining to such matters.

XXIII. Amendments to PCAOB Standards

With the adoption of Auditing Standard No. 16, the Board adopted related communication requirements to other PCAOB standards. These amendments were made to the following standards, among others:

- Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*;
- AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*;
- AU sec. 317, *Illegal Acts by Clients*;
- AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*; and
- AU sec. 722, *Interim Financial Information*.

The Board is amending AU sec. 722 to be consistent with Auditing Standard No. 16. Some commenters suggested that the amendments to AU sec. 722 should clarify that the accountant ("accountant" is the term used in AU sec. 722) is not

[87] SEC, *Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers*, Exchange Act Release No. 62991 (Sept. 24, 2010).

required to repeat communications that were made as part of the annual audit. Other commenters suggested that the amendments to AU sec. 722 should become effective for interim periods following the first annual period in which Auditing Standard No. 16 becomes effective and that, otherwise, implementing the amendments prior to the first annual communication under Auditing Standard No. 16 would likely result in unnecessarily expanding the communication requirements related to the auditor's review of interim information.

The objective of a review of interim financial information pursuant to AU sec. 722 is to provide the accountant with a basis for communicating whether the accountant is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles.[88] Procedures for conducting a review of interim financial information generally are limited to analytical procedures, inquiries, and other procedures that address significant accounting and disclosure matters relating to the interim financial information to be reported.[89] A review may bring to the accountant's attention significant matters affecting the interim financial information, but it does not provide assurance that the accountant will become aware of all significant matters that would be identified in an audit.[90]

AU sec. 722.18 requires the accountant to make inquiries of members of management who have responsibility for financial and accounting matters, including but not limited to, matters concerning unusual or complex situations that may have an effect on the interim financial information. Examples of situations about which the accountant would ordinarily inquire of management include, among other things, significant, unusual, or infrequently occurring transactions; application of new accounting principles; changes in accounting principles or the methods of applying them; and trends and developments affecting accounting estimates.[91]

An amendment to AU sec. 722 states that when conducting a review of interim financial information, the accountant also should determine whether any of the matters described in Auditing Standard No. 16, as they relate to interim financial information, have been identified.[92] This requirement is similar to the current requirement for the accountant to refer to AU sec. 380 for matters to communicate to the audit committee when conducting an interim review.[93]

Additionally, the amendments to AU sec. 722 recognize that management might communicate some or all of the matters related to the company's accounting policies, practices, estimates, and significant unusual transactions described in paragraph 12 of Auditing Standard No. 16. If management communicates any of these matters, the accountant does not need to communicate them at the same level of detail as management, as long as certain criteria are met. However, any omitted or inadequately described matters should be communicated to the audit committee.

The amendment to AU sec. 722.35 also indicates that any communication the accountant may make about the entity's accounting policies, practices, estimates, and significant unusual transactions as applied to its interim financial reporting generally would be limited to the effect of significant events, transactions,

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[88] AU sec. 722.07.

[89] AU sec. 722.15.

[90] AU sec. 722.07.

[91] AU sec. 722.55.

[92] Amendment to AU sec. 722.34.

[93] *Id*.

and changes in accounting estimates that the accountant considered when conducting the review of interim financial information. The amendments to AU sec. 722 do not require that the communications to the audit committee repeat the annual communications but, rather, that the communication be related to the accountant's findings while performing the interim review procedures.

The Board determined not to defer the effective date for quarterly reviews as suggested by some commenters. Deferral of the effective date would result in AU sec. 380 continuing to apply to communications relevant to quarterly reviews, while Auditing Standard No. 16 simultaneously would require communications relating to the annual audit. Auditing Standard No. 16 requires timely communications of matters in connection with the annual audit to be made throughout the year under audit. These communications would, therefore, be made at or near the time that related communications are required in connection with quarterly reviews. Applying Auditing Standard No. 16 for the annual audit and AU sec. 380 for quarterly reviews could cause some degree of complexity because auditors would be required to apply two different standards when communicating important information to the audit committee. Therefore, the Board is making Auditing Standard No. 16 effective for quarterly reviews of fiscal years beginning on or after December 15, 2012.

In addition to avoiding having two co-existing and differing standards, implementing Auditing Standard No. 16 in the first quarter of 2013 should benefit audit committees by providing for the communication of significant information during the most current period. Also, and as discussed above, the objective of a review of interim financial information differs significantly from that of an audit, and any communication the accountant would make pertaining to interim financial reporting would be limited, as discussed in AU sec. 722, to matters the accountant considered when conducting the review of interim financial information.

The proposed amendments to other PCAOB standards accompanying the reproposed standard included an amendment to AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents.* This amendment would have required the auditor to communicate to the audit committee material misstatements if the client did not agree to revise the accompanying information. This amendment was removed from the amendments accompanying Auditing Standard No. 16 because the Board has proposed to supersede AU sec. 551 as part of its standard-setting project related to auditing supplemental information.[94]

QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, states that to minimize the risk of misunderstandings regarding the nature, scope, and limitations of services to be performed, policies and procedures should provide for obtaining an understanding with the client regarding those services.[95] To align with Auditing Standard No. 16, the reproposed standard proposed an amendment to QC sec. 20 to change "client" to "audit committee." One commenter indicated that QC sec. 20 applies to attest engagements as well as to audit engagements. This commenter suggested that instead of replacing "client" with "audit committee," a clarifying footnote be added to the word "client" to indicate that with respect to a financial statement audit

[94] *See Proposed Auditing Standard, Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards.* PCAOB Release No. 2011-005 (July 12, 2011).

[95] QC sec. 20.16.

or an audit of internal control over financial reporting, the auditor is required to establish an understanding of the terms of the audit engagement with the audit committee. The Board considered this comment and decided not to amend QC sec. 20 at this time. Changes to the Board's quality control standards will be considered as part of the Board's quality control standard-setting project.

Appendix 5

Comparison of the Objectives and Requirements of Auditing Standard No. 16, *Communications with Audit Committees*, to the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants

Introduction

This appendix compares certain significant differences between the objectives and requirements of Auditing Standard No. 16, *Communications with Audit Committees,* and the analogous standards of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants.

The analogous IAASB standards are:

- International Standard on Auditing ("ISA") 210, *Agreeing the Terms*
- ISA 260, *Communication with Those Charged with Governance.*

The analogous ASB standards[1] are:

- AU-C Section 210, *Terms of Engagement*, and
- AU-C Section 260, *The Auditor's Communication With Those Charged with Governance.*

Other standards of the IAASB and the ASB, respectively, were considered in this comparison to the extent that they include comparable requirements, including:

- ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*,
- ISA 450, *Evaluation of Misstatements Identified during the Audit*,
- ISA 570, *Going Concern,*
- ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors),*
- ISA 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements,*
- AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit*,
- AU-C Section 450, *Evaluation of Misstatements Identified During the Audit,*

[1] In October 2011, the ASB issued Statement on Auditing Standards ("SAS") No. 122, *Statements on Auditing Standards: Clarification and Recodification*, which contains the Preface to Codification of Statements on Auditing Standards, *Principles Underlying an Audit Conducted in Accordance with Generally Accepted Auditing Standards*, and 39 clarified SASs. SAS 122 identifies the section within the AICPA codification with "AU-C" section numbers. *See* http://www.aicpa.org/RESEARCH/STANDARDS/AUDITATTEST/Pages/audit%20and%20attest%20standards.aspx.

- AU-C Section 600, *Using the Work of Others —Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors),*
- SAS 118, *Other Information in Documents Containing Audited Financial Statements*, and
- SAS 126, *The Auditor's Consideration of An Entity's Ability to Continue as a Going Concern* (Redrafted).

The information presented does not cover the application and explanatory material in the IAASB standards or ASB standards.[2]

This appendix is provided for informational purposes only. It is not a summary of or a substitute for Auditing Standard No. 16 itself, which is presented in Appendix 1 of this release. This comparison may not represent the views of the IAASB or ASB regarding the interpretation of their standards.

Objectives

PCAOB

Auditing Standard No. 16 supersedes AU sec. 310, *Appointment of the Independent Auditor*, and AU sec. 380, *Communication With Audit Committees*. Given the responsibility of many audit committees for the appointment and retention of the auditor, Auditing Standard No. 16 combines the requirements from the Board's standards, AU secs. 310 and 380, into one auditing standard.

Auditing Standard No. 16 includes four objectives for the auditor, which reflect both the appointment and retention of the auditor as well as the overall communication responsibilities. The objectives of the auditor are to:

a. Communicate to the audit committee the responsibilities of the auditor in relation to the audit and establish an understanding of the terms of the audit engagement with the audit committee;
b. Obtain information from the audit committee relevant to the audit;
c. Communicate to the audit committee an overview of the overall audit strategy and timing of the audit; and
d. Provide the audit committee with timely observations arising from the audit that are significant to the financial reporting process.

IAASB and ASB

ISA 210 and AU-C Section 210 both include an objective to establish whether the preconditions for an audit are present. Auditing Standard No. 16 does not include this objective, because some of the related requirements in the ISA

[2] Paragraph A59 of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing,* indicates that the application and other explanatory material section of the ISAs "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA." Paragraph A63 of AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, states that although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AUC section."

and SAS are not applicable to audits performed under PCAOB standards, such as determining whether the financial reporting framework is acceptable. For audits performed under PCAOB standards, 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.

Both ISA 260 and AU-C Section 260 include an objective for the auditor to promote effective two-way communication between the auditor and those charged with governance. Although Auditing Standard No. 16 does not include a similar objective, the standard encourages effective two-way communication between the auditor and the audit committee. As stated in Auditing Standard No. 16, "communicate to," is meant to encourage effective two-way communication between the auditor and the audit committee throughout the audit to assist in understanding matters relevant to the audit.

Appointment and Retention

Significant Issues Discussed with Management In Connection with the Auditor's Appointment or Retention

PCAOB

Auditing Standard No. 16 requires the auditor to discuss with the audit committee any significant issues that the auditor discussed with management in connection with the appointment or retention of the auditor, including significant discussions regarding the application of accounting principles and auditing standards.

IAASB and ASB

ISA 210 and AU-C Section 210 do not include a similar requirement.

Establish an Understanding of the Terms of the Audit

PCAOB

Auditing Standard No. 16 requires the auditor to establish an understanding of the terms of the audit engagement with the audit committee. This understanding includes communicating to the audit committee the objective of the audit, the responsibilities of the auditor, and the responsibilities of management. Paragraph 6 of Auditing Standard No. 16 requires the auditor to record the understanding of the terms in an engagement letter and provide the engagement letter to the audit committee annually. In addition, paragraph 6 of Auditing Standard No. 16 includes a requirement for the auditor to have the engagement letter executed by the appropriate party or parties on behalf of the company. If the appropriate party or parties are other than the audit committee, or its chair on behalf of the audit committee, the auditor should determine that the audit committee has acknowledged and agreed to the terms of the engagement.

Additionally, Auditing Standard No. 16 requires the auditor to decline to accept, continue, or perform the engagement if the auditor cannot establish an understanding of the terms of the audit engagement with the audit committee.

IAASB and ASB

ISA 210 and AU-C Section 210 require the auditor to agree on the terms of the audit engagement with management and, where appropriate, those charged with governance.

ISA 210 and AU-C Section 210 require the engagement letter to be in writing, although there is no requirement that the engagement letter be given to the audit committee or that it be signed by the audit committee, or its chair on behalf of the audit committee, or that it otherwise be acknowledged by the audit committee. Additionally, ISA 210 states that for recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. Accordingly, ISA 210 permits the auditor to not send a new audit engagement letter or other written agreement each period.

AU-C Section 210 requires the auditor to assess whether circumstances require the terms of the audit engagement to be revised. If the auditor concludes that the terms of the preceding engagement need not be revised for the current engagement, the auditor should remind management of the terms of the engagement, and the reminder should be documented.

Both ISA 210 and AU-C Section 210 also establish requirements for the auditor to determine whether the preconditions for an audit exist. Auditing Standard No. 16 does not include similar requirements, as these requirements were either not applicable to audits performed under PCAOB standards or were addressed through the requirements in Auditing Standard No. 16 for establishing an understanding of the terms of the audit engagement with the audit committee.

ISA 210 requires the auditor to determine whether there are any conflicts between the financial reporting standards and additional requirements supplemented by law or regulation. AU-C Section 210 does not include similar requirements. Auditing Standard No. 16 also does not include similar requirements as they are not relevant to the audits performed under PCAOB standards.

ISA 210 and AU-C Section 210 also include requirements regarding limitation of scope prior to audit engagement acceptance, other factors affecting audit engagement acceptance, and acceptance of a change in the terms of the audit engagement. Auditing Standard No. 16 does not include such requirements as they are not applicable to audits performed under PCAOB standards.

AU-C Section 210 also includes requirements regarding initial audits and reaudits. Auditing Standard No. 16 does not include similar requirements, although similar requirements are included in the Board's standard, AU sec. 315, *Communications Between Predecessor and Successor Auditors*.

Additionally, ISA 260 and AU-C Section 260 include a requirement for the auditor to communicate with those charged with governance the form, timing, and expected general content of communications. Auditing Standard No. 16 does not include this requirement; however, Auditing Standard No. 16 does not preclude the auditor from communicating these matters to the audit committee.

Obtaining Information and Communicating the Audit Strategy

Obtaining Information Relevant to the Audit

PCAOB

Auditing Standard No. 16 requires the auditor to inquire of the audit committee about whether it is aware of matters relevant to the audit, including, but not

limited to, violations or possible violations of laws or regulations. This requirement complements the requirement in Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* for the auditor to make inquiries of the audit committee, or equivalent (or its chair) about risks of material misstatement, including inquiries related to fraud risks.[3]

IAASB and ASB

ISA 260 and the AU-C Section 260 do not contain a similar requirement for the auditor to inquire of matters that might be relevant to the audit, including, but not limited to, knowledge of violations or possible violations of laws or regulations. However, ISA 240 and AU-C Section 240 require the auditor to make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected, or alleged fraud affecting the entity.

Overall Audit Strategy, Significant Risks, and Timing of the Audit

PCAOB

Auditing Standard No. 16 requires the auditor to communicate to the audit committee an overview of the overall audit strategy, including the timing of the audit, and discuss with the audit committee the significant risks identified during the auditor's risk assessment procedures. As part of communicating the overall audit strategy, paragraph 10 of Auditing Standard No. 16 requires the auditor to communicate the following matters to the audit committee, if applicable:

a. The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results related to significant risks;

b. The extent to which the auditor plans to use the work of the company's internal auditors in an audit of financial statements; c. The extent to which the auditor plans to use the work of internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee when performing an audit of internal control over financial reporting;

d. The names, locations, and planned responsibilities of other independent public accounting firms or other persons, who are not employed by the auditor, that perform audit procedures in the current period audit; and

e. The basis for the auditor's determination that the auditor can serve as principal auditor, if significant parts of the audit are to be performed by other auditors.

In addition, Auditing Standard No. 16 requires the auditor to communicate to the audit committee significant changes to the planned audit strategy or the significant risks initially identified and the reasons for such changes.

IAASB and ASB

ISA 260 and AU-C Section 260 require the auditor to communicate an overview of the planned scope and timing of the audit. However, ISA 260 and AU-C Section 260 do not require the auditor to communicate significant changes to the planned scope and timing of the audit. Further, ISA 260 and AU-C Section 260

[3] Paragraphs 5.f. and 54-57 of Auditing Standard No. 12.

do not include requirements for the auditor to communicate information about specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results related to significant risks, the auditor's use of the work of internal auditors, or the auditor's use of the work of other company personnel and third parties working under the direction of management or the audit committee.

ISA 260 and AU-C Section 260 do not include requirements for the auditor to communicate information about the names, locations, and planned responsibilities of other independent public accounting firms or other persons, who are not employed by the auditor, that perform audit procedures in the current period audit.

However, ISA 600 and AU-C Section 260, include requirements for the auditor to communicate certain matters to those charged with governance including: an overview of the type of work to be performed on the financial information of the components; an overview of the nature of the group engagement team's planned involvement in the work to be performed by the component auditors on the financial information of significant components; instances where the group engagement team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work; any limitation on the group audit; and fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls or other where the fraud resulted in a material misstatement of the group financial statements. In addition, AU-C Section 260 also includes a requirement for the auditor to communicate the basis for the decision to make reference to the audit of a component auditor in the auditor's report on the group financial statements.

Results of the Audit

Accounting Policies and Practices, Estimates, and Significant Unusual Transactions

PCAOB

Auditing Standard No. 16 requires the auditor to communicate certain matters relating to accounting policies and practices, estimates, and significant unusual transactions. However, Auditing Standard No. 16 acknowledges that if management communicates matters related to accounting policies and practices, estimates, and significant unusual transactions to the audit committee, the auditor does not need to communicate these matters at the same level of detail as management as long as the auditor (1) participated in management's discussion with the audit committee, (2) affirmatively confirmed to the audit committee that management has adequately communicated these matters, and (3) with respect to critical accounting policies and practices, identified for the audit committee those accounting policies and practices that the auditor considers critical. In addition, the auditor is required to communicate any omitted or inadequately described matters to the audit committee.

Matters to be communicated include:

a. Significant accounting policies and practices—(1) management's initial selection of, or changes in, significant accounting policies or the application of such policies in the current period; and (2) the effect on financial statements or disclosures of significant accounting policies in (i) controversial areas or (ii) areas for which

there is a lack of authoritative guidance or consensus, or diversity in practice.

b. All critical accounting policies and practices to be used, including: (1) the reasons certain policies and practices are considered critical; and (2) how current and anticipated future events might affect the determination of whether certain policies and practices are considered critical.

c. Critical accounting estimates—(1) a description of the process management used to develop critical accounting estimates; (2) management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity; and (3) any significant changes management made to the processes used to develop critical accounting estimates or significant assumptions, a description of management's reasons for the changes, and the effects of the changes on the financial statements.

d. Significant unusual transactions—(1) 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; and (2) the policies and practices management used to account for significant unusual transactions.

IAASB

ISA 260 requires the auditor to communicate the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

ASB

AU-C Section 260 requires the auditor to communicate the auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures. AU-C Section 260 also provides that, when applicable, the auditor should determine that those charged with governance are informed about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

The ISAs and the AU-Cs do not include a similar requirement for communicating significant unusual transactions.

Auditor's Evaluation of the Quality of the Company's Financial Reporting

PCAOB

Auditing Standard No. 16 requires the auditor to communicate the following matters to the audit committee:

a. Qualitative aspects of significant accounting policies and practices.

   1) The results of the auditor's evaluation of, and conclusions about, the qualitative aspects of the company's significant accounting policies and practices, including situations in which the auditor identified bias in management's judgments about the amounts and disclosures in the financial statements; and

2) The results of the auditor's evaluation of the differences between (i) estimates best supported by the audit evidence and (ii) estimates included in the financial statements, which are individually reasonable, that indicate a possible bias on the part of the company's management.

b. Assessment of critical accounting policies and practices. The auditor's assessment of management's disclosures related to the critical accounting policies and practices, along with any significant modifications to the disclosure of those policies and practices proposed by the auditor that management did not make.

c. Conclusions regarding critical accounting estimates. The basis for the auditor's conclusions regarding the reasonableness of the critical accounting estimates.

d. Significant unusual transactions. The auditor's understanding of the business rationale for significant unusual transactions.

e. Financial statement presentation. The results of the auditor's evaluation of whether the presentation of the financial statements and related disclosures are in conformity with the applicable financial reporting framework, including the auditor's 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, and the bases of amounts set forth.

f. New accounting pronouncements. Situations in which, as a result of the auditor's procedures, the auditor identified a concern regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting.

g. Alternative accounting treatments. All alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the auditor.

IAASB

ISA 260 requires the auditor to communicate the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates, and financial statement disclosures. The ISA provides that, when applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity.

The ISAs do not include a similar requirement for communicating the auditor's understanding of the business rationale for significant unusual transactions.

ASB

AU-C Section 260 requires the auditor to communicate the auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures. When applicable the auditor should:

a. Explain to those charged with governance why the auditor considers a significant accounting practice that is acceptable under

the applicable financial reporting framework not to be most appropriate to the particular circumstances of the entity, and

b. Determine that those charged with governance are informed about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

The AU-Cs do not include a similar requirement for communicating the auditor's understanding of the business rationale for significant unusual transactions.

Other Information in Documents Containing Audited Financial Statements

PCAOB

When other information is presented in documents containing audited financial statements, Auditing Standard No. 16 requires the auditor to communicate to the audit committee the auditor's responsibility under PCAOB rules and standards for such information, any related procedures performed, and the results of such procedures.

AU sec. 550, *Other Information in Documents Containing Audited Financial Statements,* requires that if the auditor identifies a material inconsistency in the other information presented in documents containing audited financial statements, and the other information is not revised by management to eliminate the material inconsistency, the auditor should communicate the material inconsistency to the audit committee. The auditor should also consider other actions, such as revising the audit report to include an explanatory paragraph describing the material inconsistency, as described in paragraph .11 of AU sec. 508, *Reports on Audited Financial Statements*, withholding the use of the report in the document, and withdrawing from the engagement. The auditor should also communicate a material misstatement of fact to the client and the audit committee, if the material misstatement of fact is not corrected.

IAASB

ISA 720 requires that if the auditor identifies a material inconsistency in the other information in documents containing audited financial statements and revision of the other information is necessary and management refuses to make the revision, then the auditor shall communicate this matter to those charged with governance and (a) include in the auditor's report an Other Matter(s) paragraph describing the material inconsistency in accordance with ISA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*; or (b) withhold the auditor's report; or (c) withdraw from the engagement, where withdrawal is possible under applicable law or regulation. ISA 720 also requires the auditor to notify those charged with governance of the auditor's concern regarding the other information and take any further appropriate action if there is a material misstatement of fact in the other information which management refuses to correct.

ASB

SAS 118 contains similar requirements to those in Auditing Standard No. 16.

Difficult or Contentious Matters for which the Auditor Consulted

PCAOB

Auditing Standard No. 16 requires the auditor to communicate to the audit committee matters that are difficult or contentious for which the auditor consulted outside the engagement team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process.

IAASB and ASB

ISA 260 and AU-C Section 260 do not include a similar requirement.

Management Consultation with Other Accountants

PCAOB

When the auditor is aware that management consulted with other accountants about significant auditing or accounting matters and the auditor has identified a concern regarding such matters, Auditing Standard No. 16 requires the auditor to communicate to the audit committee his or her views about such matters that were the subject of such consultation.

IAASB

ISA 260 does not include a similar requirement.

ASB

AU-C Section 260 requires the auditor to communicate to those charged with governance the auditor's views about matters that were the subject of management's consultations with other accountants on accounting or auditing matters when the auditor is aware that such consultations occurred.

Going Concern

PCAOB

Paragraph 17 of Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee, when applicable, certain matters relating to the auditor's evaluation of the company's ability to continue as a going concern. These matters include (a) If the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the conditions and events that the auditor identified that, when considered in the aggregate, indicate that there is substantial doubt; (b) If the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern is alleviated, the basis for the auditor's conclusion, including elements the auditor identified within management's plans that are significant to overcoming the adverse effects of the conditions and events; (c) if the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time remains, the effects, if any, on the financial statements and the adequacy of the related disclosure and the effects on the auditor's report.

IAASB

ISA 570 requires the auditor to communicate events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. This communication includes whether the events or conditions constitute a material uncertainty; whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements; and the adequacy of related disclosures in the financial statements.

ASB

SAS 126 requires the auditor to communicate with those charged with governance the nature of the conditions or events identified, the possible effects on the financial statements and the adequacy of related disclosures in the financial statements, and the effects on the auditor's report if, after considering identified conditions or events in the aggregate and after considering management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains.

Uncorrected and Corrected Misstatements

PCAOB

Auditing Standard No. 16 requires the auditor to provide the audit committee with the schedule of uncorrected misstatements related to accounts and disclosures that the auditor presented to management. Auditing Standard No. 16 also requires the auditor to discuss with the audit committee, or determine that management has adequately discussed with the audit committee, the basis for the determination that the uncorrected misstatements were immaterial, including the qualitative factors considered. Additionally, Auditing Standard No. 16 requires the auditor to communicate that uncorrected misstatements or matters underlying those uncorrected misstatements could potentially cause future-period financial statements to be materially misstated. Auditing Standard No. 16 also requires the auditor to communicate to the audit committee those corrected misstatements, other than those that are clearly trivial, related to accounts and disclosures that might not have been detected except through the auditing procedures performed, and discuss with the audit committee the implications that such corrected misstatements might have on the company's financial reporting process.

IAASB and ASB

ISA 450 and AU-C Section 260 include requirements for the auditor to communicate uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report. The auditor's communication shall identify the material uncorrected misstatements individually. Additionally, under ISA 450 and the AU-C Section 260, the auditor is required to communicate the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

ISA 450 and AU-C Section 450 require the auditor to request that uncorrected misstatements be corrected. Auditing Standard No. 16 does not require the auditor to make this request, because under SEC rules the financial statements are required to reflect all material correcting adjustments identified by the auditor.

ISA 450 does not include a requirement for the auditor to communicate corrected misstatements to those charged with governance. AU-C Section 260 requires the auditor to communicate material, corrected misstatements that were brought to the attention of management as a result of audit procedures.

Material Written Communication

PCAOB

Auditing Standard No. 16 requires the auditor to communicate to the audit committee other material written communications between the auditor and management.

IAASB and ASB

ISA 260 and AU-C Section 260 require the auditor to communicate to those charged with governance written representations the auditor is requesting.

Disagreements with Management

PCAOB

Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee any disagreements with management about matters, whether or not satisfactorily resolved, that individually or in the aggregate could be significant to the company's financial statements or the auditor's report. Auditing Standard No. 16 also states that disagreements with management do not include differences of opinion based on incomplete facts or preliminary information that are later resolved by the auditor obtaining additional relevant facts or information prior to the issuance of the auditor's report.

IAASB

The ISAs do not include a similar requirement.

ASB

AU-C Section 260 requires the auditor to communicate disagreements with management, if any.

Other Matters

PCAOB

Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee other matters arising from the audit that are significant to the oversight of the financial reporting process. This communication includes, among other matters, complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit and the results of the auditor's procedures regarding such matters.

IAASB and ASB

ISA 260 and AU-C Section 260 include a similar requirement for the auditor to communicate other matters to those charged with governance that, in the auditor's professional judgment, are significant and relevant to the oversight of the financial reporting process.

Form and Documentation of Communications

PCAOB

Auditing Standard No. 16 requires the auditor to communicate the matters in the standard to the audit committee, either orally or in writing, unless otherwise specified in Auditing Standard No. 16. In addition, the standard also requires the auditor to document the communications in the work papers whether such communications took place orally or in writing. Auditing Standard No. 16 also requires the auditor to include a copy of or a summary of management's communication provided to the audit committee in the audit documentation, if as part of its communications to the audit committee, management communicated some or all of the matters related to accounting policies and practices, estimates, significant unusual transactions, or uncorrected misstatements to the audit committee, and, as a result, the auditor did not communicate these matters at the same level of detail as management.

IAASB

ISA 260 requires the auditor to communicate in writing with those charged with governance regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. Written communication need not include all matters that arose during the course of the audit.

ASB

AU-C Section 260 requires the auditor to communicate in writing with those charged with governance significant findings or issues from the audit if, in the auditor's professional judgment, oral communication would not be adequate. This communication need not include matters that arose during the course of the audit that were communicated with those charged with governance and satisfactorily resolved.

Timing

PCAOB

Auditing Standard No. 16 requires the communications to the audit committee to be made in a timely manner and prior to the issuance of the auditor's report.[4]

IAASB and ASB

ISA 260 and AU-C Section 260 require that the auditor should communicate with those charged with governance on a timely basis.

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[4] Auditing Standard No. 16 includes the following exception for registered investment companies – Consistent with SEC Rule 2-07 of Regulation S-X, 17 C.F.R. §210.2-07, in the case of a registered investment company, audit committee communication should occur annually, and if the annual communication is not within 90 days prior to the filing of the auditor's report, the auditor should provide an update, in the 90-day period prior to the filing of the auditor's report, of any changes to the previously reported information.

Topical Indexes

For ease of use and reference, topical indexes exist at the end of each of the following sections:

- Auditing Standards
- Interim Standards
  - — U.S. Auditing
  - — Attestation Standards
  - — Code of Professional Conduct
  - — Independence Standards Board
  - — Quality Control
- PCAOB Staff Guidance
- Select Rules of the Board